Supreme Court, U.S.
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No. ___

In The
Supreme Court of the United States

ELLIS Y. LOVELL, ET AL.,
Petitioners,

v.

RICHARD A. LEVIN, TAX COMMISSIONER OF OHIO,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of Ohio

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

Whether the Supreme Court of Ohio erred by not holding that the State of Ohio exceeded its sovereign authority under the Constitution when Respondent interpreted and applied 26 U.S.C. 641(c) contrary to the plain language of Federal law and in opposition to Internal Revenue Service practice.

Whether the Supreme Court of Ohio erred in not resolving the ambiguity in the statutory provisions of 26 U.S.C. 641(c) and 26 U.S.C. 671 in favor of Petitioners, as required by the United States Supreme Court's decision in *Gould v. Gould*, 245 U.S. 151 (1917).

PARTIES TO THE PROCEEDING

Pursuant to Rule 14.1(b), the following list identifies all of the parties appearing here and before the Supreme Court of Ohio.

Petitioners herein and Appellants below are Ellis Lovell, Franklin and Melinda Lovell, Jack and Virginia Caldwell, Frank and Christine Vestfall, and William and Denise Huelsman.

Respondent herein and Appellee below is Richard A. Levin, Tax Commissioner of Ohio.

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OPINIONS BELOW

The opinion of the Supreme Court of Ohio is reported at 877 N.E.2d 667, and is reprinted in the Appendix to the Petition ("Pet. App.") at 1a. The Ohio Board of Tax Appeals decisions are not reported, but are available through the Board's online docket at http://bta.ohio.gov/070302DK.htm., and are reprinted at Pet. App. 15a - 34a.

JURISDICTION

The Supreme Court of Ohio entered its judgment on November 20, 2007. This Court has jurisdiction under 28 U.S.C. 1257(a).

STATUTES INVOLVED

This case involves provisions of the Internal Revenue Code, 26 U.S.C. 1, *et seq.* Further, this case involves the Supremacy Clause of Art. VI of the U.S. Constitution.

STATEMENT OF THE CASE

Under the United States Constitution, the Federal Government and the States have concurrent taxing power. Absent intergovernmental immunities or particular limitations in the Constitution, both the Federal Government and the States may tax the same activity. Both governments may decide to leave the same activity untaxed. One government may decide to tax an activity that the other leaves free from tax.

In formulating its tax laws, however, neither government may co-opt the other's sovereign authority. Congress may induce, through its spending power, a State to adopt particular laws, but Congress may not command a State to pass any particular piece of legislation. *New York v. United States* 505 U.S. 144 (1992). In like manner, a State may decide to tax the same activity that Congress has taxed, or it may decide to tax an activity that Congress has decided not to tax. In a word, the State can establish its own set of legal tax liabilities. What a State lacks the sovereign authority to do, however, is to co-opt Federal sovereignty and define the content of Federal law.

In this case, Ohio, through a peremptory definition of Federal tax law by Respondent, denied Petitioner a Federal tax benefit in the face of the plain meaning of Federal law and at odds with the practice of the Internal Revenue Service. As Chief Justice Marshall declared, "[T]he States have no power, by taxation or otherwise, to retard, impede, burden, or in any manner control the operations of the constitutional laws enacted by Congress to carry into execution the powers vested in the General Government." *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 436 (1819).

Like many States, Ohio "piggybacks" its tax code upon the Federal tax code. Specifically, whatever constitutes the adjusted gross income of the taxpayer under the Internal Revenue Code, as reported on Federal tax Form 1040, is accepted by Ohio as taxable income reported on the State Form IT-1040. Should

Ohio wish to make adjustments to a State taxpayer's liability as measured by the taxpayer's Federal adjusted gross income, it can do so through the exercise of its concurrent sovereign tax authority. But in doing so, the legislature of Ohio changes Ohio's tax regime, not the Federal.

In this case, a change in Federal law (26 U.S.C. 1361(2) and 26 U.S.C. 641(c)) provided that the income of an Electing Small Business Trust (ESBT) would be taxed at the highest marginal tax rate set forth in 26 U.S.C. 1(e), but the owners of shares in an ESBT would no longer have to report the income as personal income on Form 1040. The taxpayer's Federal adjusted gross income was accordingly lowered and that figure was passed through to Ohio's IT-1040. Ohio did not tax the income of trusts such as ESBTs. To address this situation, twice a bill in the Ohio legislature sought to establish a State tax on ESBT trusts. Twice that effort failed.

Thus, without authority from the Ohio legislature, Respondent could not levy a State tax on the income of ESBTs, nor could he add to the taxpayer's State adjusted gross income from what was reported on Federal Form 1040. Instead, Respondent, on its own initiative, decided to change Federal tax liability by declaring that the exemption that the taxpayer claimed and that had been approved by the Internal Revenue Service on his Federal tax form was invalid under Federal law, thus requiring a higher Federal adjusted gross income to pass through to the Ohio resident's State tax liability. Our Constitution of

mixed and separate sovereignties does not allow such a startling reach of power. The action by Respondent goes beyond the invalidity of a State law impeding or obstructing Federal law. In this case, Respondent by diktat changed the content of Federal law itself, an act confirmed and approved by the Supreme Court of Ohio in its decision below.

In our system, no sovereign, howsoever limited by the Constitution, can substitute its will for another sovereign's lawful exercise of its lawmaking power. That would violate the fundamental premise of Chief Justice Marshall's opinion in *McCulloch*: "The only security against the abuse of [the taxing] power is found in the structure of the Government itself. In imposing a tax, the legislature acts upon its constituents. This is, in general, a sufficient security against erroneous and oppressive taxation." *McCulloch*, 17 U.S. at 428. Respondent is without political accountability to the people of the United States. If he is permitted to change Federal tax law on his own initiative, he denies to the constituents of the Federal government their representational rights.

Moreover, the effect of Respondent's revising of Federal tax law was to increase the amount of taxes owed to the State of Ohio by Petitioners and others, and to decrease the amount of income tax owed to the Federal government. No State official has the power to change Federal law in that fashion.

Respect for the sovereign authority of both the State and Federal governments impels the conclusion

that the action by the Respondent cannot be abided under our Constitution.

Neither is it availing to assert that Respondent was merely interpreting an ambiguous provision of the Federal tax code, for by a long observed rule of construction, the resolution of an ambiguous tax statute must be in favor of the taxpayer. See, e.g., *Gould v. Gould*, 245 U.S. 151, 153 (1917). Recently, the vitality of that rule of construction was the subject of a colloquy between Justices Stevens and Thomas in *United Dominion Industries v. United States*, 532 U.S. 822 (2001), discussed in detail below.

What can be noted at this point is the rule that ambiguous tax regulation must be resolved in favor of taxpayers has parallels throughout our legal system whenever vital interests are at stake. For example, under the rubric of the "Clear Statement" rule, the Supreme Court has required that for Congress, under the Commerce Clause, to displace ordinary State competence in areas of criminal law, Congress must do so "unambiguously." *United States v. Bass*, 404 U.S. 336, 349 (1971). Similarly, a law will be interpreted so far as it is possible so that it will not conflict with the United States' obligations under treaty or international law. The States may discriminate against interstate commerce only if Congress "expressly" consents to it. *Prudential Insurance Company v. Benjamin*, 328 U.S. 408, 433(1946). States receiving Federal funding cannot be held to conditions imposed by Congress unless those conditions are clearly stated in a Federal statute that provides the States with advance notice of

their obligations. *South Dakota v. Dole*, 433 U.S. 203, 207 (1987). Courts will enforce the extraterritorial reach of Federal law only under a clear statement rule. *American Banana Co. v. United Fruit Co.*, 213 U.S. 347 (1907). The United States does not waive sovereign immunity unless it is clearly stated in the law. See *Immigration & Naturalization Serv. v. St. Cyr*, 533 U.S. 289, 333-34 (2001) (Scalia, J., dissenting on other grounds). Even the standard rule of statutory construction of a purportedly unconstitutional statute requires that a statute may not be invalidated on its face merely because in some "conceivable" set of circumstances, the statute may operate unconstitutionally. *United States v. Salerno*, 481 U.S. 739, 745 (1987).

In each foregoing instance, the Court presumes a "default" position on principles of fundamental importance that cannot be overcome save by the explicit command of positive law, whether the "default" be the States' traditional police powers, *Bass*, *supra*; the idea that Congress would normally not place the United States under an international delict; that the Commerce Clause normally precludes State discrimination against interstate commerce, *Prudential, supra*; that jurisdiction is normally only territorial, *American Banana, supra*; that sovereign immunity is the prerogative of the State, *St. Cyr., supra*; and that Congress will not be presumed to have knowingly violated the Constitution, *Salerno, supra.*

The default position for taxpayers is that a person's property is presumed to be his own, and that

government may not take anyone's property except by his consent as articulated through the representational process. That, in any event, was the basis on which our nation fought its Revolution. See, *James Otis, The Rights of the British Colonies Asserted and Proved, in J.P. Green, Colonies to Nation, 1763-1789 (1975).* It follows that a person cannot be presumed to have given consent unless that consent is phrased in clear terms within the law by which the government now asserts a right to his property. As a fundamental premise of our representational constitutional order, therefore, ambiguities in tax laws must be resolved in favor of the taxpayer.

A. Factual Background

1. Petitioners[1] were each owners of closely-held businesses incorporated under Ohio law. For Federal income tax purposes, Petitioners' corporations were all small business corporations taxed in accordance with Subchapter S of the Internal Revenue Code. In the year 2000, all Petitioners were residents of Ohio.

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[1]This Petition will speak generally about each of Petitioners and will rely on the facts set forth in the record concerning each Petitioner. A general description of the facts applies to each Petitioner with the only distinctions between them being the identity of the entities owned, the name of the separate Petitioners' ESBTs, and the dates on which each Petitioner's ESBT was established. See, Supreme Court of Ohio Opinion at (Pet. App. at 1a).

2. In 1996, Congress passed the Small Business Job Protection Act of 1996, P.L. No. 104-188, 110 Stat. 1755 ("Act"), which provided significant new opportunities for business owners, such as Petitioners, that owned stock in S corporations. The provisions of the Act looked towards revitalizing the utility of S corporations for closely held business owners, with the Act's most significant provision being the introduction of an "electing small business trust" ("ESBT") as an eligible S corporation shareholder. See, *Electing Small Business Trust: The Good, The Bad and the Ugly*, at http://www.abanet.org/rppt/publications/magazine/1997/so97gbu.html (visited January 30, 2008).

3. The ESBT provision, 26 U.S.C. 1361(e), provides that any trust may make an "electing small business trust" election. This is not disputed by either Respondent or the Ohio courts (Pet. App. at 2a, 55a-56a). Congress passed the ESBT provision to provide S corporation shareholders with flexibility in their estate planning and in their ability to transfer wealth. Prior to the ESBT provision, grantor trusts were eligible S corporation shareholders, but, upon the death of the grantor, the trust would soon cease to qualify as a shareholder. Thus, after the death of a grantor, the shares were required to be transferred out of the prior grantor trust, or in limited circumstances, a qualified subchapter S trust ("QSST") election could be made. Congress understood that ownership of shares through a QSST limited S corporation owners, with regard to estate planning, since QSSTs require all income of the QSST to be distributed annually. To provide S corporation shareholders with estate

planning flexibility enjoyed by owners of other forms of closely-held businesses, Congress created the ESBT. The paramount feature of the ESBT provision is that, instead of requiring ESBTs to distribute all income annually to its beneficiaries, as was the case with QSSTs, the ESBT could make variable ("sprinkle") distributions to beneficiaries. Since ESBTs provide flexibility in estate planning, and ESBTs do not result in the termination of an S election upon the death of its settlor, as was the case upon the death of the grantor of a grantor trust, many grantor trusts made ESBT elections.

4. Concurrent with Congress granting flexibility to S corporation shareholders by enacting the ESBT, Congress subjected ESBTs to "special" tax rules. As part of the Act, Congress enacted 26 U.S.C. 641(c) entitled "Special Rules for the Taxation of Electing Small Business Trusts." Pursuant to 26 U.S.C. 641(c), ESBTs were taxed at the highest marginal tax rate set forth in 26 U.S.C. 1(e) (entitled "Estates and Trusts"), on all of the ESBT's income (Pet. App. at 35a). Congress' statutory framework authorized ESBTs to own shares in S corporations, and the ESBTs did not have to distribute all income annually, but, the ESBTs accumulated income would be taxed to the ESBT at the highest marginal rates set forth in 26 U.S.C. 1(e). The result was, for grantor trusts that made an ESBT election, the grantor forewent paying tax on the S corporation's income *individually* in accordance with the graduated tax rates; instead, the S corporation's income was taxed to the ESBT itself, and each dollar was subject to tax at

the highest marginal tax rate set forth in 26 U.S.C. 1(e).

5. After enactment of the ESBT provision, Petitioners, who previously owned their shares in their respective S corporations, individually or through grantor trusts, each filed an electing small business trust election with respect to their respective trusts in accordance with 26 U.S.C. 1361(e)(2). In 1998 and 1999, Petitioners reported all income of the ESBTs on Form 1041 (U.S. Income Tax Return For Estates and Trusts) for Federal income tax purposes and paid tax at the highest marginal rate set forth in 26 U.S.C. 1(e). Since each Petitioner's ESBT terminated before December 29, 2000, Petitioners reported all income of their ESBT for the year 2000 through the date Petitioners' ESBTs terminated, on Form 1041 for Federal income tax purposes. For 1998, 1999 and 2000 (through December 28), since Petitioners reported all their ESBT income on Form 1041, Petitioners did not report the ESBTs income on their individual Form 1040 (U.S. Individual Income Tax Return).

6. Following Ohio law, then, each Petitioner did not include the income of their ESBTs in their individual Ohio taxable income as reported on a Form IT-1040. In Ohio, the starting point to compute an individual's Ohio taxable income is such individual's Federal adjusted gross income as reported on Form 1040. Because each Petitioner's ESBT income was reported on Form 1041, such income was not included in their Federal adjusted gross income. In addition, Ohio statutory law did not impose a tax on trusts until

the year 2002; therefore, because each Petitioner's ESBT income was taxed to the trust, itself, pursuant to the plain language of 26 U.S.C. 641(c), each Petitioner was not, under Ohio law at that time, required to pay Ohio income tax with respect to the ESBT income (reported on Form 1041 for Federal income tax purposes).

7. On two occasions in 1998 and 1999, the Ohio legislature noted the deficiency in Ohio's statutory income tax laws from its failure to tax trusts, and legislation (i.e., House Bill 802, 122nd General Assembly and House Bill 139 123rd General Assembly) was introduced to subject trusts to tax in Ohio. On both attempts, the legislation failed. Respondent in neither 1998 nor 1999 imposed a tax on Petitioners, nor any other Ohio taxpayer, with respect to the income reported by such taxpayers on Form 1041 with respect to their ESBTs.

8. On January 19, 2000, with a retroactive effective date of January 1, 2000, Respondent issued Information Release 2000-01 providing that grantor trusts are not allowed to make electing small business trust elections under 26 U.S.C. 1361 (Pet. App. at 48a). The Information Release provided that Ohio "will require" its citizens to include ESBT income in their Federal adjusted gross income (computed on Form 1040) (Pet. App. at 45a). Respondent noted that various tax practitioners had a different interpretation of the Internal Revenue Code, but the interpretation that Respondent decreed was correct was that grantor trusts could not make an electing small business trust

election: all income reported by an individual on Form 1041 with respect to his ESBT must be reported on Form 1040 and therefore included in such individual's Federal adjusted gross income.

9. To ensure Ohio taxpayers complied with Respondent's decree set forth in Information Release 2000-01, Respondent issued Information Release 2001-04, dated July 3, 2002. Pursuant to Information Release 2001-04, Respondent informed Ohio taxpayers that failure to comply with the initial notice would result in the assessment of tax, interest, interest penalty, failure to pay tax penalty and statutory fraud penalties.

10. At no time were Petitioners assessed a tax by the Internal Revenue Service for failing to report the ESBT income on their Form 1040. Petitioners introduced but could not present, due to a stay issued in all proceedings at the Ohio Board of Tax Appeals, evidence establishing that the practice of the Internal Revenue Service in 1998, 1999 and 2000 (prior to December 29, 2000), was to permit grantor trusts that made an ESBT election to report such income on Form 1041. Due to the conflict between the Internal Revenue Service's interpretation and application of the law concerning the reporting of ESBT income in the relevant years, and Respondent's interpretation of such Federal law, Ohio taxpayers were presented with the uncomfortable decision whether to pay the Federal government less money (by reporting ESBT income on Form 1040 as opposed to on Form 1041) thereby risking incorrectly reporting their Federal income tax

liability or to ignore Respondent's threat of fraud penalties and report the ESBT income on Form 1041 resulting in less tax revenue being collected by Respondent.

11. On or about December 26, 2000, to remedy the actions of certain United States taxpayers who established a Guamanian Trust thereby avoiding Federal income taxes, the Internal Revenue Service issued Treasury Regulation 1.641(c)-1 stating that if an ESBT owns S corporation stock then the income of the ESBT with respect to the S corporation stock will be treated as a separate trust and such income will be taxed to the grantor of the ESBT (Pet. App. at 38a). Treasury Regulation 1.641(c)-1 expressly provided that such Regulation did not apply to ESBTs having a tax year ending on or before December 28, 2000 (Pet. App. at 44a). Specifically, the Treasury Regulation at 1.641(c)-1(k) provides ". . . paragraphs (a), (b), (c) and (1), Example 1, of this section are applicable for taxable years of ESBTs that end on and after December 29, 2000." Thus, the express provisions of Federal law, enacted pursuant to Congress' plenary power to issue Federal income tax laws, clearly establishes that an ESBT owning S corporation stock is only required to be taxed under 26 U.S.C. 671, if such ESBT has a tax year ending on or after December 29, 2000. The dissenting opinion of the Supreme Court of Ohio deemed the preceding effective date of the Treasury Regulation as decisive on the issue; since each Petitioner's ESBT terminated before December 29, 2000, Petitioners were not required to include the ESBT income in their individual Federal income on Form 1040 (Pet. App. at

61a).

12. As evidenced by the foregoing, Respondent exceeded Ohio's sovereign authority when he improperly interpreted the Internal Revenue Code and applied the Internal Revenue Code in direct conflict with the Federal government's application of the Internal Revenue Code to enable Ohio to collect additional income taxes the result of which would have been the Internal Revenue Service collecting less income taxes from Ohio's taxpayers.

B. Proceedings Below

Petitioners are individuals who filed joint Ohio and Federal income tax returns for tax year 2000. As in 1998 and 1999, Petitioners did not include on their Federal Form 1040 or their Ohio Form IT-1040 any of the income generated by the S-corporation shares held in their ESBTs. Respondent, acting on the alleged authority of Information Release 2000-01, issued assessments to Petitioners alleging that the income earned by their ESBTs was properly taxable to Petitioners individually. Petitioners responded by filing Petitions for Reassessment pursuant to Ohio law. Petitioners did not receive a response for over 2 years. In September 2003, Petitioner Vestfall was granted a hearing.

During the hearing, Respondent's agent was unable to provide the support on which the assessment was based, but indicated that Respondent's Final Determination (formal response to Petition for

Reassessment under Ohio law) would be forthcoming before the end of 2003. A Final Determination was not issued until June 2006.

Upon issuance of the Final Determination, Petitioners appealed to the Ohio Board of Tax Appeals (BTA). The BTA affirmed the Final Determination without affording Petitioners a hearing. The BTA affirmation was based on its decision in *Knust v. Wilkins, Case No. 2004-M-53, Ohio Board of Tax Appeals (2006), aff'd by Knust v. Wilkins, 111 Ohio St.3d 331 (2006).* Thereafter, Petitioners appealed to the Supreme Court of Ohio.

The Supreme Court of Ohio noted that Petitioners' provided evidence that "some or all of [Petitioners] terminated their trusts before December 29, 2000, when a Federal regulation we cited in *Knust* [i.e. Treas. Reg. 1.641(c)-1] took effect" (Pet. App. at 9a). However, the Court found that the Treasury Regulation "simply 'reinforces' the conclusion that we and the BTA had drawn from the relevant statutes." *Id.* That "conclusion" was that Internal Revenue Code Section 671 was clear on its face that "the income earned by a grantor trust passes through to the grantor and is taxed to him or her under Sections 671 to 679... [n]othing in the statutory provision cited by [Petitioners]--Section 641(c)... suggests that that principle changes when the grantor trust is designated as an ESBT" (Pet. App. at 10a).

The Court was unpersuaded by Petitioners' argument that the Internal Revenue Code was clear on

its face that income earned by *any* ESBT, including grantor trusts, was taxed to the trust at the highest marginal rate set forth in Section 1(e) of the Internal Revenue Code. Further, to the extent there was no support in the statute (nor in any case law) for the Court's implication that Section 671 somehow "trumped" Section 641(c), the Court unreasonably refused to recognize any ambiguity in the Internal Revenue Code concerning the interplay between these two statutes. The Court did not address Petitioners' Supremacy Clause arguments, even though the Board of Tax Appeals opinion (at Footnote 1) confirmed Petitioner Vestfall preserved Constitutional challenges for review; Petitioner raised Constitutional challenges in both the Petition for Reassessment and Notice of Appeal to the BTA (Pet. App. at 19a-20a).

Thus, the Supreme Court of Ohio arbitrarily held that Section 671, and not Section 641(c), governed the taxation of grantor trusts that made an ESBT election (Pet. App. at 14a).

REASONS FOR GRANTING THE PETITION

This case presents an issue of critical importance regarding the allocation of sovereign authority within our Federal system. The political accountability of both Congress and the State of Ohio to their respective constituents have been called into question by the unilateral action of Respondent. Further, this case is of no small moment not only to taxpayers in Ohio and each of the other forty-nine States, but to tax practitioners tasked with advising

their clients as to the proper application of Federal and State tax laws. Lastly, we should not but wonder at the idea that a State Tax Commissioner can change the impact of Federal tax law and thereby affect the Federal government's ability to impose and collect income taxes, and not incidentally, increase the State government's "take" in tax revenue at the expense of the Federal government. Chief Justice Marshall famously declared that "the power to tax is the power to destroy." In this case, Respondent reverses the equation but to the same effect. He uses the power to destroy in order to gain the power to tax. By arrogating to himself the power to change Federal tax regulations, he gained the power to impose a State tax liability.

The State of Ohio, through its sovereign legislative processes, could have decided to tax those trusts left untaxed by its own law. Alternatively, Ohio, through its legislative processes could have declared that income from ESBTs would be counted as part of a taxpayer's Ohio adjusted gross income. It did neither. But not even the State of Ohio could legislate a change in Federal tax liability. Still less may the Ohio Tax Commissioner on his own initiative.

Faced with the fact that the ruling of Respondent both contradicted Internal Revenue Service practice and resulted in a gain to the coffers of Ohio, the Supreme Court of Ohio sought to excuse this untoward reach of power by opining,

> [W]e conclude that David and Susan should have included on their individual

> Federal income tax returns the income that the grantor trusts earned. The failure of the Internal Revenue Service to insist that the returns be changed to reflect the trust income as personal income-a failure explained, perhaps, by the fact that ESBT trusts pay "the highest rate of tax" under Section 641(c)(2)(A), Title 26, U.S. Code, on any taxable income does not prevent the Tax Commissioner or this court from applying the Federal statutes as they are written (Pet. App. at 58a).

The Federal government vests exclusive authority in the Department of Treasury to issue all needful rules and regulations concerning the implementation of the Internal Revenue Code. See, 26 U.S.C. 7805. But the decision of the Supreme Court of Ohio now vests a State tax official with the authority to direct how State citizens are to fill out their Federal tax returns, even when the Internal Revenue Service has acted in a contrary fashion, and even if the Federal government could lose tax revenue as a result. In this case, Respondent, without regard to the impact his interpretation would have on the Federal government, usurped the powers exclusively vested in the Department of Treasury when issuing his interpretation of the Internal Revenue Code, while at the same time threatening the imposition of substantial penalties if Ohio Taxpayers did not comply.

Petitioners request that this Court undo the

current harm, and prevent future harm, to taxpayers and the Federal government by issuing a ruling that a State tax agency may not define provisions of the Internal Revenue Code contrary to law or Internal Revenue Service determination or practice. This case, necessarily requires a ruling that the Respondent's actions exceeded the sovereign capacity of the State of Ohio within our federated constitutional system.

The Federal laws in question concern the interplay between 26 U.S.C. 641(c) and 26 U.S.C. 671, prior to the Secretary issuing interpretive Treasury Regulation 1.641(c)-1 on or about December 26, 2000 (effective December 29, 2000). Petitioners fully concede that the interpretive Treasury Regulation removes the Federal tax benefit they enjoyed prior to December 28, 2000. That Regulation, issued in accordance with the Internal Revenue Code's prohibition on retroactive Regulations, does not affect Petitioners rights under Federal law prior to that date. In fact, it stands in contradiction to what the Internal Revenue Service had permitted prior to December 28, 2000. The reason Treasury Regulation Section 1.641(c)-1 was issued was to address an issue outside of the elements of the present case. The Regulation was issued to clarify an ambiguity with respect to the interplay between the statutory provisions of Federal law, which ambiguity had been exploited by certain taxpayers (not Petitioners herein) to avoid paying any United States income tax by establishing Guamanian Trusts.

The two actual conflicts in Respondent's

interpretation and enforcement of the Federal law are: (1) prior to the enactment of Treasury Regulation 1.641(c)-1, any trust that made an electing small business trust election (under 26 U.S.C. 1361) was subject to tax pursuant to the special rule applicable to electing small business trusts (i.e., 26 U.S.C. 641(c)); and, (2) Ohio's enforcement of the requirements of Treasury Regulation 1.641(c)-1 as of the date January 1, 2000 is in actual conflict with the Treasury Department's declaration that the effective date of Treasury Regulation 1.641(c)-1 is December 29, 2000. If Respondent's action in this case is validated, in any future case where a provision of the Internal Revenue Code is purportedly ambiguous Respondent would be able to override Federal law and practice, allowing the State to collect more tax revenues from its residents while the Federal government could collect less revenue. In this case, if the hundreds of taxpayers complied with Respondent's interpretation of the Internal Revenue Code, then such taxpayers would not have paid taxes with respect to their ESBT income at the highest marginal tax rates set forth in 26 U.S.C. 1(e), but rather would have paid Federal income taxes pursuant to the graduated tax rates set forth in 26 U.S.C. 1. Thus, the Federal government would have lost significant amounts of tax dollars. As this Court long ago stated, "taxes are the lifeblood of government, and their prompt and certain availability an imperious need." *Bull v. United States*, 295 U.S. 247 (1935).

Constitutional form is important to our system. There are appropriate ways to accomplish legislative objectives, and there are those that the Constitution

prohibits. The State of Ohio could have levied a separate tax on the income of ESBTs. It could have declared that the income from such trusts would be counted in a State taxpayers adjusted gross income on the State's IT-1040 Form. What the State of Ohio could not do, and what the Respondent attempted to do, was to change the content of Federal law to suit its own tax objectives. It was an action that the United States Constitution, at its most fundamental level, does not permit.

I. By overriding the Internal Revenue Services' interpretation of the Federal income tax laws, the State Tax Commissioner threatens a power of Congress granted to it by the Constitution. U.S. Const. Am. XVI.

No case presents a greater potential threat to the Federal government's ability to lay and collect taxes unimpeded from the powers of the several States than this case. Here, a State Tax Commissioner has ordered the citizens of Ohio to report their Federal income taxes in a manner that would result in Ohio collecting more income taxes and the Federal government collecting less. But for a deficiency in Ohio's laws, which did not authorize the taxation of trusts, and the Ohio legislature not passing legislation to commence taxing trusts, the Respondent would not have threatened and attempted to coerce Ohio's taxpayers to report their ESBT income in a manner that is in actual conflict with the plain language of 26 U.S.C. 641 and the express effective date of Treasury Regulation Section 1.641(c)-1.

In 1996, Congress enacted ESBT legislation which gave small business owners further opportunity to establish S corporations. The new legislation permitted an ESBT to accumulate income--flexibility not previously afforded to trusts that were eligible S corporation shareholders. Concurrently, Congress established 26 U.S.C. 641(c), which by its plain language provided that accumulated income of an ESBT would, for the purposes of "this Chapter," be taxed to a separate trust at the highest rate set forth in 26 U.S.C. 1(e) (Pet. App. at 35a). The objectives of Congress clearly demonstrate that, in exchange for the flexibility afforded by the ESBT provisions, an ESBT would be required to pay tax at the highest rates on all its income. Petitioners, for Federal income tax purposes, adhered to Congress' statutory framework and objectives and reported their ESBT income on Form 1041 and paid taxes at the highest rates set forth in 26 U.S.C. 1(e).

Despite Petitioners' adherence to Federal law, Respondent threatened to impose statutory fraud penalties on Petitioners if Petitioners did not report their ESBT income, individually, on Form 1040 and the corresponding Ohio IT-1040. To the extent Petitioners complied, Congress' objectives would not have been achieved as each Petitioners' ESBT would (i) not have been taxed to the separate trust as required by 26 U.S.C. 641(c) and (ii) the ESBT income would have been taxed pursuant to graduated tax brackets under 26 U.S.C. 1, and not at the highest marginal tax rate set forth in 26 U.S.C. 1(e). If the acts by Respondent, dictating how Ohio taxpayers should report their

Federal income tax obligations, remain valid under Ohio law, they would stand as an obstacle to the execution of the full purposes and objectives of Congress and as such, the Supremacy Clause of the Constitution is invoked. *Jones v. Rath Packing Co.*, 430 U.S. 519 (1977); U. S. Const. Art. VI, cl. 2. As this Court has previously held, State law is pre-empted if that law actually conflicts with Federal law. *Pacific Gas & Elec. Co. v. State Energy Resources Conservation and Development Comm'n,* 461 U.S. 190 (1983). But Ohio law could not validly authorize the Respondent to change Federal law. The action was constitutionally infirm at its root.

No act by a State can be more egregious than the present, where, in its own interest, Ohio is interfering with the powers granted to the Federal government by the XVI Amendment to the Constitution to lay and collect taxes. Threatening taxpayers with the imposition of statutory fraud penalties if Petitioners do not adhere to Respondent's unilateral decree of the meaning of Federal law is a greater threat to the Supremacy of Federal law than if the Ohio legislature passed actual legislation that conflicted with Federal law. At no time can the Federal government be assured of prompt and certain availability of taxes, "the lifeblood of government," if a State tax commissioner threatens such States citizens to report their Federal tax obligations in the manner decreed by the State, notwithstanding the citizens already reporting their Federal tax obligations in a manner permitted by Federal law. See, *Bull v. United States*, 295 U.S. 247 (1935). As in this case, to the extent

Petitioners complied with Respondent's decree, the Federal government would have lost tens of millions of dollars of tax revenues.

Respondent and the Supreme Court of Ohio find comfort in the fact that Treasury Regulation 1.641(c)-1 sets forth a similar interpretation of 26 U.S.C. 641(c) as that decreed twelve months earlier by Respondent. Besides the fact that Treasury Regulation 1.641(c)-1 has never been challenged as to its validity (which if challenged Petitioners surmise arguably would be overturned as it is an interpretive regulation of a statute that is clear on its face, see *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984)), Respondent and the Supreme Court of Ohio (with the exception of the dissenting opinion) ignore the fact that Treasury Regulation 1.641(c)-1 does not apply to ESBTs that terminated before December 29, 2000, as did those of Petitioners. Even the United States, which was losing substantial Federal income tax revenues due to the rampant Federal income tax evasion occurring by taxpayers (not including Petitioners) establishing offshore ESBTs to avoid paying any Federal income tax, did not simply assess tax on individuals based on the language of 26 U.S.C. 641(c) and 26 U.S.C. 671 until after the effective date of the Treasury Regulation. Respondent was the lone authoritative figure applying the Federal income tax laws on January 1, 2000, in the manner established by the Treasury Department to have an effective date of December 29, 2000.

Undoubtedly, this Court must intervene.

Federal programs which "by their nature are and must be uniform in character throughout the Nation" necessitate formulation of controlling Federal rules. *United States v. Yazell*, 382 U.S. 341 (1966). While this present seizure by Respondent of Congress' plenary power to lay and impose taxes and of the Treasury Department's power to issue all needful rules and regulations is before this Court, it is an ongoing occurrence in Ohio and will undoubtedly continue unless this Court intervenes by overturning the decision of the Supreme Court of Ohio, thereby placing restraints on Respondent's proclaimed powers, and affirming the sovereign rights and concomitant limits of the States within our Federal system.

II. This Case raises the question of whether *Gould, supra*, remains the standard for interpreting ambiguous tax statutes.

A. In this case, the Opinion of the Supreme Court of Ohio unreasonably and arbitrarily held that the Internal Revenue Code provisions on the taxation of grantor trusts which have made an ESBT Election under 26 U.S.C. 1361(e)(2) were not ambiguous.

Thus far, Petitioners have asserted that the decision of the Supreme Court of Ohio is in direct conflict with Federal law as it relates to the taxation of ESBTs pursuant to 26 U.S.C. 641(c). Alternatively, Petitioners contend that the decision of the Supreme Court of Ohio cannot be upheld to the extent that it not only conflicts with existing Federal law, but is an

unreasonable interpretation of, Federal law, and therefore void pursuant to this Court's opinion in *Williams v. Taylor*, 529 U.S. at 399.

In *Williams*, this Court reversed the decision of the Supreme Court of Virginia in denying relief to an individual convicted of murder based on ineffective counsel. In overturning the Virginia Court, this Court held that where the highest court of a State renders a decision that is both contrary to, and involved an unreasonable interpretation of Federal law, such decision cannot stand. *Williams*, 529 U.S. 362, 399. While *Williams* was a *habeus* case, dealing with portions of the Antiterrorism and Effective Death Penalty Act (AEDPA), the logic of this Court in overturning the Virginia Court in *Williams* is applicable to the case *sub judice*: where a State court of last resort interprets a Federal statute in a manner that is unreasonable, such interpretation cannot be allowed to stand as the law of that State.

The instant matter involves Ohio's interpretation of 26 U.S.C. 671 and 641(c).

Section 671 provides:

> Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits

> against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D (Pet. App. at 37a).

Section 671 suggests and has been interpreted by the Federal courts to mean that, generally, income earned by a grantor trust is taxed to the grantor of the trust, and not to the trust itself. See, e.g., *Rothstein v. United States*, 735 F.2d 704, 709 (2nd Cir. 1984); *Vercio v. Commissioner*, 73 T.C. 1246, 1255 (1980).

However, in 1996, Congress enacted the Small Business Job Protection Act, which introduced for the first time the "ESBT." As previously noted, Congress created the ESBT to provide for flexible estate planning for small business owners. Therefore, it is important to note that one of the reasons the ESBT provisions were enacted was to provide a benefit to grantor trusts.

26 U.S.C. 1361(e)(1)(A) provides that "any" trust can make an ESBT election, which necessarily includes grantor trusts. This is consistent with the intent of Congress in enacting Section 1361(e), discussed above. Contemporaneous with Congress' enactment of Section 1361(e), was the enactment of Section 641(c), entitled "Special Rules For Taxation of Electing Small Business

Trusts." Section 641(c) provides in pertinent part:

> 641(c)(1) In General. For purposes of this chapter - 641(c)(1)(A): the portion of any electing small business trust which consists of stock in one or more S corporations shall be treated as a separate trust; and
>
> Section 641(c)(1)(B): The amount of tax imposed by this Chapter on such separate trust shall be determined with the modifications of paragraph (2)...
>
> 641(c)(2)(A): Except as provided in section 1(h), the amount of the tax imposed by section 1(e) shall be determined by using the highest rate of tax set forth in section 1(e). (emphasis added) (Pet. App. at 35a).

As Petitioners argued before the Supreme Court of Ohio, the Internal Revenue Code was *at best* ambiguous on how grantor trusts that were also ESBTs were to be taxed. On the one hand, Section 671 provided that grantor trust income is taxed to the grantor if the grantor is treated as the owner of any portion of the trust. On the other hand, Section 641(c) provided that "For purposes of this Chapter" (which includes Section 671) the income of all ESBTs, including grantor trusts that made an ESBT election, was to be taxed to the trust itself, at the highest rate set forth in Section 1(e). In fact, to the extent Section 641(c) was enacted after Section 671, it is a more

compelling argument that the later provision controlled and that ESBT income was taxable not to the grantor, but to the trust itself. The Supreme Court of Ohio rejected both the argument that Section 641(c) exclusively controlled and the argument that at best the statute was ambiguous. Rather, the Court ruled that the Internal Revenue Code required that "the income earned by a grantor trust passes through to the grantor and is taxed to him or her under Sections 671 to 679" (Pet. App. at 9a).

The Court focused on the language of Section 641(c)(1)(A) which states "the amount of tax imposed by this chapter on such separate trust shall be determined with the modifications of paragraph (2)." It held that because Section 671 taxes grantor trusts, and provides that income earned by a grantor trust is taxable to the grantor, that "the amount of tax imposed by this chapter" on grantor trusts which made an ESBT election was zero (Pet. App. at 57a). This analysis is clearly a case of the Supreme Court of Ohio trying to lift itself up by its own bootstraps.

However, no one disputed that Section 671 clearly applied to grantor trusts that did *not* make an ESBT election. Stopping the analysis at this point, however, ignores the controversy.

As explained above, Section 1361 unequivocally provides that any trust can make an ESBT election. Not only does the use of the all inclusive term "any" in the statute encompass grantor trusts, but the legislative background of Section 1361 demonstrates

that it was enacted to benefit grantor trusts. Further, Section 641(c)(1)(A) provides "the portion of *any* electing small business trust which consists of stock in one or more S corporations shall be treated *as a separate trust*" (emphasis added) (Pet. App. at 35a). Subsequently, "the amount of tax imposed by this chapter *on such separate trust*" must be taxed to the trust at the highest rate set forth in Section 1(e) (emphasis added) (Pet. App. at 35a). Therefore, the portions of Petitioners' ESBTs which consisted of S corporation stock should have been treated as a separate trust, taxed at the highest rate imposed on trusts by Section 1(e). Petitioners' position, therefore, was that their trusts were taxable under the ESBT provisions of Section 641(c) and not the grantor trust provisions of Section 671.

Reading Section 671 in a vacuum, there could be absolutely no doubt that the income of Petitioners' ESBTs was properly taxed to the trusts. However, reading it in connection with Section 641(c) casts merely the slightest hint of doubt at the position embraced by Petitioners. At the absolute worst, the interplay between Sections 641(c) and 671 creates a patent ambiguity.

Giving the Supreme Court of Ohio the benefit of the doubt for the moment, the first sentence of Section 671 does begin "[w]here it is specified in this subpart that the grantor or another person shall be treated the owner of any portion of a trust" income earned by that portion is taxed to the grantor (Pet. App. at 37a). Taken alone, this language clearly indicates that the

income is to be taxed to the grantor, not the trust. However, the remainder of that first sentence continues, providing that the grantor is to be taxed on the income only "to the extent that such [income] would be taken into account under this chapter in computing taxable income or credits against the tax of an individual" (Pet. App. at 37a). Because Section 641(c), (contained in the same chapter of the Internal Revenue Code as Section 671 (i.e., Chapter 1)), provides that income earned by an ESBT is taxable to the trust, ESBT income is *not* "taken into account under [Chapter 1] in computing taxable income or credits against the tax of an individual."

Assuming for the sake of argument that it is a reasonable interpretation of Section 671 to focus merely on the "any portion of a trust" language of the first sentence of that Section, and completely ignore the entire second half of that sentence, to the extent the "any portion" language of Section 671 is in direct conflict with the "such separate trust" language of Section 641(c), an ambiguity exists. Therefore, logic and reason dictate that at worst, the statute was ambiguous.

To be sure, Petitioners ought to "win" if either (1) the statute is clear on its face that Section 641(c) controls; or (2) the statute is ambiguous. This is by virtue of the ancient statute of construction that requires an ambiguous tax statute to be resolved in favor of the taxpayer. See, e.g., *Gould v. Gould*, 245 U.S. 151, 153 (1917). However, recent decisions by this Court have called into question whether or not this

rule still carries any weight.

B. This Court's decision in *United Dominion Industries, Inc. v. United States*, 532 U.S. 822 (2001) has engendered a debate regarding the once well-settled cannon of construction that revenue raising Statutes should be construed in favor of taxpayers.

In *United Dominion Industries, Inc. v. United States*, 532 U.S. 822 (2001), this Court decided the issue of whether an affiliated group's product liability losses ("PLL") must be figured on a consolidated single-entity basis, or whether it could be figured by aggregating the product liability losses for each individual company. *United Dominion*, 532 U.S. at 834.

In *United Dominion*, the controversy was generated somewhat by the definitional uncertainty of the term net operating loss ("NOL"). Because this Court found that the definition operated in favor of the taxpayer's position, it was held proper to combine the PLL of each group member against the NOL of the group. *Id.* at 834.

Justice Stevens, in his dissent, argued that the Internal Revenue Code was, at best, ambiguous, and that the ambiguity should be resolved in favor of the government. *Id.* at 842.

In concurring with the majority, Justice Thomas responded:

> I agree with the Court that the Internal Revenue Code provision and the corresponding Treasury Regulations that control consolidated filings are best interpreted as requiring a single-entity approach in calculating product liability loss. I write separately, however, because I respectfully disagree with the dissent's suggestion that, when a provision of the Code and the corresponding regulations are ambiguous, this Court should defer to the Government's interpretation. See *post*, at 1-2 (opinion of STEVENS, J.). At a bare minimum, in cases such as this one, in which the complex statutory and regulatory scheme lends itself to any number of interpretations, we should be inclined to rely on the traditional canon that construes revenue-raising laws against their drafter." *Id.* (citation omitted).

United Dominion therefore embraces conflicting notions regarding how ambiguities in the Internal Revenue Code should be resolved. The conflict may be resolved to the extent Justice Thomas characterized the case as involving the imposition of a tax, while Justice Stevens viewed the case as involving a taxpayer seeking a deduction. Indeed, Justice Stevens wrote:

> Justice Thomas accurately points to a tradition of cases construing "revenue-

> raising laws" against their drafter. See ante, at 1 (Thomas, J., concurring). However, when the ambiguous provision in question is not one that imposes tax liability but rather one that crafts an exception from a general revenue duty for the benefit of some taxpayers, a countervailing tradition suggests that the ambiguity should be resolved in the government's favor. See, e.g., *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934) (remainder of citations omitted). *Id.* at 842, n.1.

It is clear that after the *United Dominion* decision was handed down by this Court, the Internal Revenue Service has actively argued that the age old cannon embodied by the *Gould* case and its predecessors is no longer good law. Petitioners suspect that the Internal Revenue Service has construed Justice Steven's dissent to be a subversive attempt to undue the timeless cannon, by construing the case as involving a deduction and applying the rule that deductions are construed against the taxpayer.

For example, in *OfficeMax, Inc. v. United States*, 428 F.3d 583 (6th Cir. 2005), the Sixth Circuit declined to follow the government's suggestion that because the statute at issue in *OfficeMax* at least did not prevent the imposition of tax, the government's assessment of the same should be upheld. The Sixth Circuit called into question the continued validity of the *Gould* rule, but stopped short of ruling in the government's favor

because "[r]egardless of the current status of the 'traditional cannon that construes revenue-raising laws against their drafter'... the government has not identified any case establishing an opposite presumption." 428 F.3d at 594 (internal citations omitted).

In *America Online, Inc. v. United States*, Court of Federal Claims, Docket No. 03-2383-T (Fed. Cl. 2005), the Internal Revenue Service argued that "this principle [regarding ambiguities in tax statutes] was overruled by *White v. United States*, 305 U.S. 281, 292 (1938)." The *White* case involved an income tax deduction, part of the progeny of cases springing from *New Colonial Ice*, the case cited by Justice Stevens in his dissent. That the Internal Revenue Service cited this line of cases in *America Online*, a clear imposition of a tax matter, suggests that the Internal Revenue Service has become emboldened enough following the confusion created by the *United Dominion* dicta to begin an assault on the traditional cannon.

As suggested by the Sixth Circuit in *OfficeMax*, *supra*, the Federal Courts have begun looking for ways around the *Gould* rule, if not directly overturning it. In *Murphy v. Internal Revenue Service*, 493 F.3d 170 (D.C. Cir. 2007), the taxpayer argued that damages awarded for emotional distress are not included as taxable items of income under 26 U.S.C. 61, and to the extent the provisions of 26 U.S.C. 104(a)(2) (dealing with exclusion of income for certain damage awards) included as income awards for emotional distress, that an ambiguity existed and the *Gould* rule applied. 493

F.3d at 179. The D.C. Circuit, found against the taxpayer, however, suggesting that to the extent Congress amended Section 104(a)(2) to carve out awards for emotional distress from the exclusion, Section 61 must also have been "amended by implication." *Id.* at 180. Even admitting that the "amendment by implication" approach was disfavored by Federal Courts, see, e.g., *United States v. Weldon*, 377 U.S. 95, 103 n.12 (1964), the Court construed the interplay of the statutes *against* the taxpayer. 493 F.3d at 180. The *Murphy* Court therefore adopted the same approach taken by the Supreme Court of Ohio in the this case by refusing to recognize ambiguity where ambiguity existed. This effectively overrules the *Gould* rule in form, if not function, and is a prime example of Federal Courts refusing to construe ambiguities in the Internal Revenue Code in favor of the taxpayer. See also, *Comcation, Inc. v. United States*, Court of Federal Claims, Docket No. 05-515T (Fed. Cl. 2007) (holding that the *Gould* rule is a "last resort", citing *White*, *supra*).

As noted by the Sixth Circuit, given the Federal Court's treatment of the *Gould* rule post *United Dominion*, the "traditional cannon that construes revenue-raising laws against their drafter" is under attack, and this Court needs to speak on this controversy before the Federal Courts and the Internal Revenue Service complete their dismantling of the same.

C. Amidst recent clamor for widespread changes to the Internal Revenue Code, and the

inevitable ambiguities to follow, this Court needs to speak with a unified voice as to whose favor such ambiguities must be resolved.

It's no secret that wholesale tax reform is a hot issue for debate in the current political arena. See, *America Needs a Better Tax System*, The President's Advisory Panel on Federal Tax Reform, available at http://www.taxreformpanel.gov/04132005.pdf. The Bush Administration's efforts to reform the Internal Revenue Code is a true bipartisan effort, echoed by many prominent Democrats. See, e.g., *Building One Economy with Tax Reform To Reward Work*, John Edwards, available at http://www.johnedwards.com/issues/tax-reform. There is a real possibility that, in the very near future, America may experience the biggest overhaul of the Internal Revenue Code in over twenty years. With new laws come new problems in interpreting those laws. Indeed, amending a body of law can be more taxing than drafting new law, to the extent the new laws will have to be reconciled with what remains of the old. Inevitably, ambiguities will arise. While the Treasury Department is primarily charged with resolving ambiguities, "[t]he Treasury's relaxed approach to amending its regulations to track Code changes is well documented." *United Dominion*, *supra*, at 836. Therefore, Federal and State courts will be called upon to resolve these ambiguities.

It is of vital importance that this Court direct how those ambiguities be resolved. Not only will this save taxpayers millions of dollars in legal fees

otherwise spent challenging court interpretations of ambiguous provisions, but the benefit to the government itself will be substantial, as Federal dockets will be free from *Gould* type challenges.

Therefore, it is imperative that this Court speak with a unified voice, hold that the decision of the Supreme Court of Ohio unreasonably refused to find at least an *ambiguity* in the interplay of Sections 641(c) and 671, affirm the traditional cannon that revenue-raising laws are construed against the government, and provide direction to courts on how to interpret the Federal tax laws.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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LOVELL v. LEVIN, 116 Ohio St.3d 200 (2007)
2007-Ohio-6054, 877 N.E.2d 667

LOVELL ET AL., APPELLANTS, v. LEVIN, TAX COMMR., APPELLEE., CALDWELL ET AL., APPELLANTS, v. LEVIN, TAX COMMR., APPELLEE., VESTFALL ET AL., APPELLANTS, v. LEVIN, TAX COMMR., APPELLEE. HUELSMAN ET AL., APPELLANTS, v. LEVIN, TAX COMMR., APPELLEE., LOVELL, APPELLANT, v. LEVIN, TAX COMMR., APPELLEE.

Nos. 2007-0579, 2007-0580, 2007-0584, 2007-0586, and 2007-0589.

Supreme Court of Ohio.

Submitted November 7, 2007.

Decided November 20, 2007.

APPEALS from the Board of Tax Appeals, Nos. 2006-M-782, 2006-H-548, 2006-T-1054, 2006-R-549, and 2006-A-781.

Per Curiam.

{¶ 1} Several Ohio taxpayers contend in these consolidated appeals that they should not be required to pay Ohio income tax on the income earned by trusts that they created. The Tax Commissioner and the Board of Tax Appeals ("BTA") concluded, however, that

the trusts' income passed through the trusts and was taxable to the taxpayers themselves.
That conclusion of the BTA was lawful, and we therefore affirm the BTA's decision in each of the taxpayers' cases.

Facts and Procedural History

Case No. 2007-0579

{¶ 2} Appellants Franklin and Melinda Lovell are a married couple who live in Cuyahoga County. In 1998, Franklin created the Franklin A. Lovell Jr. Small Business Trust and transferred 120 shares of stock in VRC, Inc. to the trust.

{¶ 3} VRC was a Subchapter S corporation (often referred to as an "S corporation"). As this court has explained, "Subchapter S of the Internal Revenue Code (Section 1361 et seq., Title 26, U.S. Code) permits the owners of qualifying corporations to elect a special tax status under which the corporation and its shareholders receive conduit-type taxation that is comparable to partnership
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taxation." Ardire v. Tracy (1997), 77 Ohio St.3d 409, 674 N.E.2d 1155, fn. 1. "For tax purposes, a Subchapter S corporation differs significantly from a normal corporation in that the profits generated through the S corporation are taxed as personal income to the shareholders. The taxable income of an S corporation is computed essentially as if the corporation were an individual." Id.

{¶ 4} Franklin named himself as the sole trustee of his trust, and he designated that trust as an "electing small business trust" or "ESBT" under the Internal Revenue Code. See Section 641(c), Title 26, U.S. Code.

{¶ 5} On their joint Ohio income tax return for the year 2000, Franklin and Melinda Lovell did not report as personal income the income earned by the trust. The Tax Commissioner questioned that omission and issued a final determination in 2006 concluding that the trust's income should have been listed as taxable personal income on the Lovells' tax return.

{¶ 6} The Lovells challenged that decision before the BTA, which affirmed the Tax Commissioner's decision. The Lovells have now appealed to this court.

Case No. 2007-0580

{¶ 7} Appellants Jack and Virginia Caldwell were a married couple who lived in Medina County. In 1998, Virginia created the Virginia V. Caldwell Small Business Trust and transferred shares of stock in Varbros Corporation and Varbros Tool & Die Company, Inc. to the trust. Those two corporations were Subchapter S corporations.

{¶ 8} Virginia named herself as the sole trustee of her trust, and she designated that trust as an electing small business trust under the Internal Revenue Code. See Section 641(c), Title 26, U.S. Code. In March 2001, Virginia signed a document terminating the trust as of December 27, 2000.

{¶ 9} On their joint Ohio income tax return for the year 2000, Jack and Virginia reported the trust's income as personal income of theirs and paid Ohio income tax on the trust's income. They then asked the Tax Commissioner to refund more than $105,000 that they had paid for tax year 2000, claiming that the income received by the trust that year should not have been treated by Ohio as taxable personal income to Jack and Virginia themselves.

{¶ 10} The Tax Commissioner issued a final determination in 2006 denying the Caldwells' refund claim for tax year 2000. They then challenged that decision before the BTA, which affirmed the Tax Commissioner's decision. The Caldwells have now appealed to this court.

Case No. 2007-0584

{¶ 11} Appellants Frank and Christine Vestfall are a married couple who lived in Summit County. In 1999, Frank created the Frank C. Vestfall Small Business
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Trust and transferred 100 shares of stock in Contractors Manufacturing Services, Inc. to the trust. Contractors Manufacturing Services is a Subchapter S corporation.

{¶ 12} Frank named himself as the sole trustee of his trust, and he designated that trust as an electing small business trust under the Internal Revenue Code. See Section 641(c), Title 26, U.S. Code. In March 2001, Frank signed a document terminating the trust as of

December 27, 2000.

{¶ 13} On their joint Ohio income tax return for the year 2000, Frank and Christine Vestfall did not report as personal income the income earned by the trust. The Tax Commissioner questioned that omission and issued a final determination in 2006 concluding that the trust's income should have been listed as taxable personal income on the Vestfalls' tax return.

{¶ 14} The Vestfalls then challenged that decision before the BTA, which affirmed the Tax Commissioner's decision. The Vestfalls have now appealed to this court.

Case No. 2007-0586

{¶ 15} Appellants William and Denise Huelsman were a married couple who lived in Cuyahoga County. In 1998, Denise created the Denise M. Huelsman Small Business Trust and transferred shares of stock in Varbros Corporation and Varbros Tool & Die Company, Inc. to the trust. Those two corporations were Subchapter S corporations.

{¶ 16} Denise named herself as the sole trustee of her trust, and she designated that trust as an electing small business trust under the Internal Revenue Code. See Section 641(c), Title 26, U.S. Code. In March 2001, Denise signed a document terminating the trust as of December 27, 2000.

{¶ 17} On their joint Ohio income tax return for the year 2000, William and Denise reported the trust's income as personal income and paid Ohio income tax on it. They then asked the Tax Commissioner to refund more than $105,000 that they had paid for tax year 2000, claiming that the income received by the trust that year should not have been treated by Ohio as taxable personal income to William and Denise themselves.

{¶ 18} The Tax Commissioner issued a final determination in 2006 denying the Huelsmans' refund claim for tax year 2000. They then challenged that decision before the BTA, which affirmed the Tax Commissioner's decision. The Huelsmans have now appealed to this court.

Case No. 2007-0589

{¶ 19} Appellant Ellis Lovell lives in Cuyahoga County. In 1998, Lovell created the Ellis Y. Lovell Small Business Trust and transferred 120 shares of stock in VRC, Inc. to the trust. VRC, Inc. was a Subchapter S corporation.

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{¶ 20} Lovell named himself as the sole trustee of his trust, and he designated that trust as an electing small business trust under the Internal Revenue Code. See Section 641(c), Title 26, U.S.Code.

{¶ 21} On his Ohio income tax return for the year 2000, Lovell did not report as personal income the income earned by the trust. The Tax Commissioner

questioned that omission and issued a final determination in 2006 concluding that the trust's income should have been listed as taxable personal income on Lovell's tax return.

{¶ 22} Lovell then challenged that decision before the BTA, which affirmed the Tax Commissioner's decision. Lovell has now appealed to this court.

Standard of Review

{¶ 23} In reviewing a BTA decision, this court looks to see if that decision was "reasonable and lawful." Columbus City School Dist. Bd. of Edn. v. Zaino (2001), 90 Ohio St.3d 496, 497, 739 N.E.2d 783; R.C. 5717.04. This court "will not hesitate to reverse a BTA decision that is based on an incorrect legal conclusion." Gahanna-Jefferson Local School Dist. Bd. of Edn. v. Zaino (2001), 93 Ohio St.3d 231, 232, 754 N.E.2d 789. But "[t]he BTA is responsible for determining factual issues and, if the record contains reliable and probative support for these BTA determinations," this court will affirm them. Am. Natl. Can Co. v. Tracy (1995), 72 Ohio St.3d 150, 152, 648 N.E.2d 483.

{¶ 24} The burden of proof rests on the taxpayer "to show the manner and extent of the error in the Tax Commissioner's final determination." Stds. Testing Laboratories, Inc. v. Zaino, 100 Ohio St.3d 240, 2003-Ohio-5804, 797 N.E.2d 1278, ¶ 30. The Tax Commissioner's findings "are presumptively valid, absent a demonstration that those findings are clearly unreasonable or unlawful." Nusseibeh v. Zaino, 98

Ohio St.3d 292, 2003-Ohio-855, 784 N.E.2d 93, ¶ 10.

Analysis

{¶ 25} We must determine in this case whether the income earned in the year 2000 by the appellants' trusts was part of the appellants' own adjusted gross income for that year. We conclude that it was.

{¶ 26} This court resolved a nearly identical dispute last year, and our holding in that case dictates the outcome in this one. In that earlier case — Knust v. Wilkins, 111 Ohio St.3d 331, 2006-Ohio-5791, 856 N.E.2d 243 — we held that "income earned by a grantor trust is taxable to the grantor rather than to the trust itself — even if the trust is an ESBT." Id. at ¶ 31.

{¶ 27} The appellants acknowledge in their briefs that their ESBT trusts were in fact grantor trusts, meaning that they were trusts over which the creators of the trusts retained substantial control. See Black's Law Dictionary (8th Ed.2004)
Page 204
1549 (defining "grantor trust" as a "trust in which the settler retains control over the trust property or its income to such an extent that the settlor is taxed on the trust's income"). As we explained in Knust, the special ESBT status that some taxpayers like the appellants chose for their trusts "does not change the ordinary requirement that the grantor trust's income is taxed to the grantor and not to the trust itself." Knust at ¶ 25.

{¶ 28} Nonetheless, the appellants argue that Knust should not control the outcome in these cases. The appellants point first to the fact that some or all of them terminated their trusts before December 29, 2000, when a Federal regulation that we cited in Knust took effect. However, as we explained in Knust, that regulation — Section 1.641(c)-1(c), Title 26, C.F.R. — simply "reinforces" the conclusion that we and the BTA had drawn from the relevant statutes. Knust, 111 Ohio St.3d 331, 2006-Ohio-5791, 856 N.E.2d 243, at ¶ 30. The regulation, by its terms, is "applicable for taxable years of ESBTs that end on and after December 29, 2000." But, as we noted, that regulation merely "amplifies" the long-standing statutory provisions that we cited in that case. Id. at ¶ 29.

{¶ 29} According to our holding in Knust:

{¶ 30} "[T]he income earned by a grantor trust passes through to the grantor and is taxed to him or her under Sections 671 to 679, Title 26, U.S.Code. * * *

{¶ 31} "Nothing in the statutory provision cited by [the appellants in Knust and in these cases] — Section 641(c), Title 26, U.S. Code — suggests that that principle changes when the grantor trust is designated as an ESBT. That statute simply says that when an income tax is imposed on a trust, that tax is to be calculated in a specified way if the trust is an ESBT. Where, as in this case, no income tax is imposed on the trust, however, the statute does not come into play." Knust at ¶ 24, 25.

{¶ 32} The Federal regulation that took effect on December 29, 2000, was not, in other words, the basis for our holding in Knust. We instead in that case applied the Federal statutes "as they are written," Knust at ¶ 28, and we found that the BTA's decision that income earned by a grantor trust is taxable to the grantor rather than to the trust itself — even if the trust is an ESBT — was "consistent with the relevant provisions of the Internal Revenue Code." Id. at ¶ 26. The appellants' focus in these appeals on the regulation's effective date is misplaced because the statutes on which we relied in Knust were undeniably in effect throughout tax year 2000. Those statutes dictated the outcome in that case and in these appeals, and as a result of those statutes, the appellants "themselves owed State income tax on the income earned by their grantor trusts during tax year 2000." Knust at ¶ 30.

{¶ 33} The appellants next contend that any ambiguity in the relevant Federal statutes should be resolved in their favor. We never found any ambiguity in the

relevant Federal statutes in Knust, however, and we find no ambiguity in those same statutes in these appeals. We examined Sections 671 to 679, Title 26, U.S. Code, in Knust and explained that "a grantor trust can elect ESBT status, but that status does not change the ordinary requirement that the grantor trust's income is taxed to the grantor and not to the trust itself." Knust at ¶ 25. In the absence of any ambiguity in the relevant Federal statutes, our duty in

these appeals is to apply the statutes as written, just as we did in Knust. See State v. Kreischer, 109 Ohio St.3d 391, 2006-Ohio-2706, 848 N.E.2d 496, ¶ 12 ("When the language of a statute is plain and unambiguous and conveys a clear and definite meaning, there is no need for this court to apply rules of statutory interpretation").

{¶ 34} The appellants also allege that the imposition of Ohio income tax on them violates the supremacy Clause in Clause 2, Article VI of the United States Constitution, which designates the Constitution itself and all Federal laws and treaties as the "supreme Law of the Land." The appellants failed, however, to raise this constitutional claim in the notices of appeal that they filed at the BTA after the Tax Commissioner issued his final determinations in their cases.

{¶ 35} "For more than 50 years, this court's decisions interpreting the specificity requirement of R.C. 5717.02 have made clear that a notice of appeal filed with the BTA must explicitly and precisely recite the errors contained in the Tax Commissioner's final determination." Cousino Constr. Co. v. Wilkins, 108 Ohio St.3d 90, 2006-Ohio-162, 840 N.E.2d 1065, ¶ 41. We have also explained that any alleged errors not specified in the notice of appeal are not reviewable by the BTA or by this court. See, e.g., Castle Aviation, Inc. v. Wilkins, 109 Ohio St.3d 290, 2006-Ohio-2420, 847 N.E.2d 420, ¶ 44 ("This court can consider claims of error only when they were properly raised before the BTA"); Cleveland Elec. Illum. Co. v. Lindley (1982), 69 Ohio St.2d 71, 75, 23 O.O.3d 118, 430 N.E.2d 939

("Under R.C. 5717.02, a notice of appeal does not confer jurisdiction upon the Board of Tax Appeals to resolve an issue, unless that issue is clearly specified in the notice of appeal"); Lenart v. Lindley (1980), 61 Ohio St.2d 110, 114, 15 O.O.3d 152, 399 N.E.2d 1222 ("R.C. 5717.02 is a jurisdictional enactment and * * * adherence to the conditions and procedure set forth in the statute is essential"); Queen City Valves, Inc. v. Peck (1954), 161 Ohio St. 579, 583, 53 O.O. 430, 120 N.E.2d 310, quoting Black's Law Dictionary (4th Ed.1951) (R.C. 5717.02 requires the appellant to "specify" any alleged errors, and "specify" means "`to mention specifically; to state in full and explicit terms; to point out; to tell or state precisely or in detail; to particularize; or to distinguish by words one thing from another'").

{¶ 36} To be sure, the "question of whether a tax statute is unconstitutional on its face may be raised initially in the Supreme Court or the court of appeals," Page 206
even if that question was "not previously raised before the Board of Tax Appeals." Cleveland Gear Co. v. Limbach (1988), 35 Ohio St.3d 229, 520 N.E.2d 188, paragraph two of the syllabus. The appellants, however, do not cite in their briefs any State or Federal statutes that they believe are facially unconstitutional. Several of the appellants claim instead that they are raising a facial challenge to the assessments issued to them by the Tax Commissioner, but of course those assessments reflect the Tax Commissioner's application of State tax laws to their particular circumstances. The appellants are not claiming that

the State or Federal tax statutes cited in our Knust decision "always operate unconstitutionally." Black's Law Dictionary (8th Ed.2004) 244 (defining "facial challenge").

{¶ 37} In short, the appellants' constitutional claim grounded in the Supremacy Clause presents no facial challenge to a State or Federal statute. Because the appellants failed to raise that claim in the notices of appeal that they filed at the BTA, they are barred from raising it in this court
now.

{¶ 38} Finally, the appellants allege that the "maverick" Tax Commissioner has engaged in improper "rulemaking" by directing them to pay income taxes on the income earned by their grantor trusts. The argument is invalid for the reasons explained in Knust. The Tax Commissioner simply applied the law to these appellants as we did to the appellant in that earlier case. Nothing about the Tax Commissioner's actions suggests that he has flouted State or Federal law as the appellants claim.

Conclusion

{¶ 39} We held in Knust that "income earned by a grantor trust is taxable to the grantor rather than to the trust itself * * * even if the trust is an ESBT." Knust at ¶ 31. The BTA applied that straightforward decision to the appellant taxpayers in these consolidated appeals. Because the BTA's decisions were reasonable and lawful, we affirm them.

Decisions affirmed.

MOYER, C.J., and Pfeifer, Lundberg Stratton, O'Connor, Lanzinger, and Cupp, JJ., concur.

O'DONNELL, J., dissents for the reasons stated in his dissenting opinion in Knust v. Wilkins, 111 Ohio St.3d 331, 2006-Ohio-5791, 856 N.E.2d 243.

Corsaro & Associates Co., L.P.A., Joseph G. Corsaro, and Samuel J. Lauricia III, for appellants.

Marc Dann, Attorney General, and Barton A. Hubbard, Assistant Attorney General, for appellee.
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OHIO BOARD OF TAX APPEALS

Frank C. Vestfall and Christine M. Vestfall,	)
	) CASE NO. 2006-T-1054
Appellants,	) (PERSONAL INCOME) TAX)
vs.	) DECISION AND ORDER
William W. Wilkins, Tax Commissioner of Ohio,	) Affirmed on Appeal) November 20, 2007) Ohio Supreme Court
Appellee.	)

APPEARANCES: Slip Opinion No. 2007-Ohio-6054

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Entered March 2, 2007

Ms. Margulies, Mr. Eberhart, and Mr. Dunlap concur.

The Board of Tax Appeals considers this matter following receipt of responses to an order requiring the parties to show cause as to why the commissioner's final determination should not be affirmed under authority of *Knust v. Wilkins*, 111 Ohio St.3d 331, 2006-Ohio-5791.

2

The record before us establishes that the appellants claim that the Tax Commissioner has erroneously included income and gains from their "electing small business trust," or ESBT, on their 2000 individual income tax return. In *Knust*, supra, the Supreme Court of Ohio determined that income earned by a grantor trust is taxable to the grantor rather than to the trust itself, even if the trust is an ESBT.

In their response to the show cause order, the Vestfalls assert that their situation should be distinguished from the one considered in *Knust*, supra. The Vestfalls argue that the ESBT now before us terminated prior to the December 29, 2000 effective date of Section 1.641(c)-1(k), Title 26, C.F.R. Because the Vestfalls assert that their ESBT terminated prior to the effective date of the treasury regulations, they conclude that they owe no income on the grantor trust

for tax year 2000. We disagree.

The Vestfalls rely upon Justice O'Donnell's dissent from the majority opinion in *Knust*, supra. He states in that dissent that "because this sale terminated the trusts prior to the applicability of the Treasury Regulation upon which the majority relies, the income earned by the trusts is not taxable *** individually." *Knust*, supra, at ¶ 32. We note, however, that our original *Knust* decision did not rely upon the applicability of the regulations. Instead, we determined that the income earned by a grantor trust is taxable to the grantor pursuant to the applicable statutes. We expressly found that "the regulations themselves do not control our determination herein." *Knust v. Wilkins* (Oct. 14, 2005), BTA No. 2004-M-533, unreported at 7.

3

On appeal, the Supreme Court reached a similar conclusion. The majority of the court specified, "The BTA's conclusion that income earned by a grantor trust is taxable to the grantor rather than to the trust itself – even if the trust is an ESBT – *is supported by the relevant Federal statutes*." *Knust*, supra, at ¶ 32. (Emphasis added.) See, also, *Knust*, at ¶30 (holding that the "regulation reinforces the conclusion that the BTA rightly drew from the relevant statutes"). A review of the court's opinion, in its entirety, supports the conclusion that its determination is based upon Section 641(c), Title 26, U.S. Code.

We acknowledge that the court also looked to the

regulations; nevertheless, the court found that the regulations were supportive of the statutory provisions. Id. at ¶ 29. Moreover, the court noted that a taxpayer could not rely upon the effective date of the regulations where the taxpayer filed his or her return for a taxable year ending after the regulations became effective:

> "Admittedly, that regulation is 'applicable for taxable years of ESBTs that end on and after December 29, 2000.' Section 1.641(c)-1(k), Title 26, C.F.R. David and Susan argue that the regulation does not apply to their trusts because the trusts sold the packaging company's shares on February 26, 2000. The *taxable year* in question for David and Susan's trusts ended on December 31, 2000, however, as is shown on the face of the Federal income tax returns that they filed for those trusts. Even if, as they contend, the ESBT status of their trusts ended once the packaging company's assets were sold by the trusts in February 2000, they have offered no separate tax returns suggesting that they treated the taxable year for the ESBTs as having ended on any date earlier than December 31, 2000. The regulation therefore *does* apply to them, and that regulation reinforces the conclusion that the BTA rightly drew from the relevant statutes: that David and Susan themselves owed State income tax on the income earned by their grantor

trusts during tax year 2000." Id. at ¶ 30.

4

Although the Vestfall's claim their ESBT was terminated prior to December 29, 2000, they, like the taxpayers in *Knust*, supra, filed their tax returns for 2000 for a tax year ending December 31, 2000. See S.T. at 62-92. There are no tax returns in the record suggesting that the Vestfalls treated the taxable year of the ESBT as having ended prior to December 31, 2000. Thus, the regulation does apply to the Vestfalls. Id. at ¶ 30.

In addition to the application of *Knust*, the Vestfalls argue that the commissioner is without the authority to interpret the applicable Federal statutes, and as such, had no power to issue the subject assessment. We disagree. In *Knust*, supra, the court acknowledged that, in making an Ohio income tax assessment, the commissioner has the authority to apply the Federal statutes. Id. at ¶ 28. See, also, *Buckley v. Wilkins*, 105 Ohio St.3d 350; 2005-Ohio-2166, in which the court held that 1) the General Assembly, with regard to what constitutes income for Ohio tax purposes, may refer to Federal statutes and 2) the commissioner has the statutory authority to question income tax returns and to make assessments based upon any information in his possession.[2] While

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[1] To the extent the Vestfalls argue that the commissioner's actions are unconstitutional, we remind the parties that this board lacks jurisdiction to determine the

the Vestfalls essentially argue that the commissioner applied an incorrect interpretation to the Federal statutes, *Knust*, supra, supports the commissioner's action.

5

Finally, the Vestfalls argue that the commissioner impermissibly extended the statute of limitations by issuing an assessment on the 2000 tax year but not issuing a final determination on their petition for reassessment until June 15, 2006. The

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facts on constitutional issues or to declare a statute unconstitutional. *Cleveland Gear Co. v. Limbach* (1988), 35 Ohio St.3d 229, and *MCI Telecommunications Corp. v. Limbach* (1994), 68 Ohio St.3d 195. See, also, *Valvoline Instant Oil Change, Inc. v. Tracy* (1997), 78 Ohio St.3d 53; *NACCO Industries v. Tracy* (June 7, 1996), BTA No. 1995-K-1210, unreported, affirmed on other grounds (1997), 79 Ohio St.3d 314. Contentions regarding the possible violations of the Equal Protection that this board lacks jurisdiction to determine the facts on constitutional issues or to declare a statute unconstitutional. *Cleveland Gear Co. v. Limbach* (1988), 35 Ohio St.3d 229, and *MCI Telecommunications Corp. v. Limbach* (1994), 68 Ohio St.3d 195. See, also, *Valvoline Instant Oil Change, Inc. v. Tracy* (1997), 78 Ohio St.3d 53; *NACCO Industries v. Tracy* (June 7, 1996), BTA No. 1995-K-1210, unreported, affirmed on other grounds (1997), 79 Ohio St.3d 314. Contentions regarding the possible violations of the Equal Protection and Supremacy Clauses have been set out by the parties to preserve the issue for a court's review, if necessary. *Bd. of Edn. of South-Western City Schools v. Kinney* (1986), 24 Ohio St.3d 184.

Vestfalls note that their petition for reassessment was filed on June 25, 2002. They had a hearing before the commissioner on September 2, 2003, at which time, the Vestfalls represent, they were informed that a determination would be forthcoming by the end of 2003. Instead, the commissioner's determination was issued nearly three years later. The Vestfalls note that the delay has caused interest to accumulate on the assessment.

Although characterized as a violation of the statute of limitations, the Vestfalls actually seek to apply the doctrine of laches to bar the commissioner's actions.[3] However, the doctrine of laches, like estoppel, does not generally operate to the detriment of the State. *Bd. of Pharmacy v. Frantz* (1990), 51 Ohio St.3d 143; *Dept. of Transportation v. Sullivan* (1988), 35 Ohio St.3d 137. This is so even when State employees make misleading or confusing statements. *Sekerak v. Fairhill Mental Health Ctr.* (1986), 25 Ohio St.3d 38. We have previously found that the doctrine of laches does not operate to prevent the Tax Commissioner from issuing assessments. *Z Corp. v. Tracy* (Oct. 2, 1992), BTA Case No.1991-N-417, unreported. Moreover, the doctrine of laches, like estoppel, is an equitable remedy. We note that the Board of Tax

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[3] There is no question that the assessment itself was issued within the statute of limitations. See R.C. 5747.13.

Appeals has no express or implied equity jurisdiction. *Columbus Southern Lumber Co. v. Peck* (1953), 159 Ohio St. 564. As a creature of statute, we have only the jurisdiction, power, and duties expressly given by the General Assembly. *Steward v. Evatt* (1944), 143 Ohio St. 547; *Leiphart Lincoln-Mercury, Inc. v. Bowers* (1958), 107 Ohio App. 259.

In the instant matter, it appears that the commissioner issued the final determination just after we issued our decision in *Knust,* supra. At about the same time, the commissioner issued a multitude of determinations involving ESBTs. We cannot say that his decision to hold this and other similar cases until the BTA spoke on the ESBT issue was unreasonable. Moreover, although the Vestfalls cite to the interest accumulating on the assessment, they ignore the fact that they could have avoided interest charges by paying the assessment in full and seeking a refund.

In conclusion, upon review of the responses to the show cause order, and in accordance with *Knust,* supra, and the evidence in the record before us, the Board of Tax Appeals affirms the Tax Commissioner's final determination.

OHIO BOARD OF TAX APPEALS

William T. Huelsman and Denise M. Huelsman	) CASE NO. 2006-R-549
Appellants,	) (PERSONAL INCOME TAX)
vs.	) DECISION AND ORDER
	) Affirmed on Appeal November 20, 2007
William W. Wilkins, Tax Commissioner of Ohio	) Ohio Supreme Court
	) Slip Opinion No. 2007-Ohio- 6054
Appellee.	)

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Entered March 2, 2007

Ms. Margulies, Mr. Eberhart and Mr. Dunlap concur.

This appeal is now considered by the Board of Tax Appeals following the December 8, 2006 issuance of an order requiring appellant to show cause why this board should not affirm the Tax Commissioner's determination herein based on the Supreme Court's holding in *Knust v. Wilkins*, 111 Ohio St.3d 331, 2006-Ohio-5791. In that decision, the court determined income earned by a grantor trust is taxable to the grantor rather than to the trust itself, even if the trust is an "electing small business trust," or ESBT.

2

Appellant filed a brief in response to the show cause order, disputing the application of the *Knust* decision to the instant facts. Appellant's claims were fully considered in an order issued this date in *Vestfall v. Wilkins*, BTA No. 2006-T-1054. Through that order, the board considered and rejected legal arguments involving the termination of the ESBT prior to the

effective date of the relevant treasury regulations and whether the commissioner is without the authority to interpret the applicable federal statutes. The board concluded that these arguments lack merit.

The board finds the same to be true in the present appeal. Even if we accept appellant's claim that his ESBT terminated prior to December 29, 2000, he has not claimed that he treated the taxable year of the ESBT as having ended prior to December 31, 2000.

Thus, based on the preponderance of the evidence in the record before us, it is the decision and order of the Board of Tax Appeals that the final determination of the Tax Commissioner must be, and hereby is, affirmed.

OHIO BOARD OF TAX APPEALS

Jack E. & Virginia V. Caldwell	) CASE NO. 2006-H-548
Appellants,	) (PERSONAL INCOME TAX)
vs.	) DECISION AND ORDER
	) Affirmed on Appeal November 20, 2007
William W. Wilkins, Tax Commissioner of Ohio	) Ohio Supreme Court
	) Slip Opinion No. 2007-Ohio- 6054
Appellee.	)

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Entered March 2, 2007

Ms. Margulies, Mr. Eberhart and Mr. Dunlap concur.

This appeal is now considered by the Board of Tax Appeals following the December 8, 2006 issuance of an order requiring appellant to show cause why this board should not affirm the Tax Commissioner's determination herein based on the Supreme Court's holding in *Knust v. Wilkins*, 111 Ohio St.3d 331, 2006-Ohio-5791. In that decision, the court determined income earned by a grantor trust is taxable to the grantor rather than to the trust itself, even if the trust is an "electing small business trust," or ESBT.

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whether the commissioner is without the authority to interpret the applicable federal statutes. The board concluded that these arguments lack merit.

The board finds the same to be true in the present appeal. Even if we accept appellant's claim that his ESBT terminated prior to December 29, 2000, he has not claimed that he treated the taxable year of the ESBT as having ended prior to December 31, 2000.

Thus, based on the preponderance of the evidence in the record before us, it is the decision and order of the Board of Tax Appeals that the final determination of the Tax Commissioner must be, and hereby is, affirmed.

OHIO BOARD OF TAX APPEALS

Ellis Y. Lovell,	) CASE NO. 2006-A-781
	)
Appellant,	) (PERSONAL INCOME
	) TAX)
	)
vs.	) DECISION AND ORDER
	)
	) Affirmed on Appeal
	) November 20, 2007
William W. Wilkins,	) Ohio Supreme Court
Tax Commissioner of	)
Ohio	)
	) Slip Opinion No. 2007-
	) Ohio- 6054
Appellee.	)

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Entered March 2, 2007

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interpret the applicable federal statutes. The board concluded that these arguments lack merit.

The board finds the same to be true in the present appeal. Even if we accept appellant's claim that his ESBT terminated prior to December 29, 2000, he has not claimed that he treated the taxable year of the ESBT as having ended prior to December 31, 2000.

Thus, based on the preponderance of the evidence in the record before us, it is the decision and order of the Board of Tax Appeals that the final determination of the Tax Commissioner must be, and hereby is, affirmed.

OHIO BOARD OF TAX APPEALS

Franklin A. & Melinda, M. Lovell, Jr.	) CASE NO. 2006-M-782
Appellants,	) (PERSONAL INCOME TAX)
vs.	) DECISION AND ORDER
	) Affirmed on Appeal November 20, 2007
William W. Wilkins, Tax Commissioner of Ohio	) Ohio Supreme Court
	) Slip Opinion No. 2007-Ohio- 6054
Appellee.	)

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Entered March 2, 2007

Ms. Margulies, Mr. Eberhart and Mr. Dunlap concur.

This appeal is now considered by the Board of Tax Appeals following the December 8, 2006 issuance of an order requiring appellant to show cause why this board should not affirm the Tax Commissioner's determination herein based on the Supreme Court's holding in *Knust v. Wilkins*, 111 Ohio St.3d 331, 2006-Ohio-5791. In that decision, the court determined income earned by a grantor trust is taxable to the grantor rather than to the trust itself, even if the trust is an "electing small business trust," or ESBT.

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whether the commissioner is without the authority to interpret the applicable federal statutes. The board concluded that these arguments lack merit.

The board finds the same to be true in the present appeal. Even if we accept appellant's claim that his ESBT terminated prior to December 29, 2000, he has not claimed that he treated the taxable year of the ESBT as having ended prior to December 31, 2000.

Thus, based on the preponderance of the evidence in the record before us, it is the decision and order of the Board of Tax Appeals that the final determination of the Tax Commissioner must be, and hereby is, affirmed.

26 U.S.C. 641(c) Special rules for taxation of electing small business trusts

(1) In general

For purposes of this chapter—

(A) the portion of any electing small business trust which consists of stock in 1 or more S corporations shall be treated as a separate trust, and

(B) the amount of the tax imposed by this chapter on such separate trust shall be determined with the modifications of paragraph (2).

(2) Modifications

For purposes of paragraph (1), the modifications of this paragraph are the following:

(A) Except as provided in section 1 (h), the amount of the tax imposed by section 1 (e) shall be determined by using the highest rate of tax set forth in section 1 (e).

(B) The exemption amount under section 55 (d) shall be zero.

(C) The only items of income, loss, deduction, or credit to be taken into account are the following:

(i) The items required to be taken into account under section 1366.

(ii) Any gain or loss from the disposition of stock in an S corporation.

(iii) To the extent provided in regulations, State or local income taxes or administrative expenses to the extent allocable to items described in clauses (i) and (ii).

No deduction or credit shall be allowed for any amount

not described in this paragraph, and no item described in this paragraph shall be apportioned to any beneficiary.

(D) No amount shall be allowed under paragraph (1) or (2) of section 1211 (b).

(3) Treatment of remainder of trust and distributions

For purposes of determining—

(A) the amount of the tax imposed by this chapter on the portion of any electing small business trust not treated as a separate trust under paragraph (1), and

(B) the distributable net income of the entire trust,

the items referred to in paragraph (2)(C) shall be excluded. Except as provided in the preceding sentence, this subsection shall not affect the taxation of any distribution from the trust.

(4) Treatment of unused deductions where termination of separate trust

If a portion of an electing small business trust ceases to be treated as a separate trust under paragraph (1), any carryover or excess deduction of the separate trust which is referred to in section 642 (h) shall be taken into account by the entire trust.

(5) Electing small business trust

For purposes of this subsection, the term "electing small business trust" has the meaning given such term by section 1361 (e)(1).

26 U.S.C. 671

Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D. No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart.

26 C.F.R. 1.641(c)-1 Electing small business trust.

(a) *In general.* An electing small business trust (ESBT) within the meaning of section 1361(e) is treated as two separate trusts for purposes of chapter 1 of the Internal Revenue Code. The portion of an ESBT that consists of stock in one or more S corporations is treated as one trust. The portion of an ESBT that consists of all the other assets in the trust is treated as a separate trust. The grantor or another person may be treated as the owner of all or a portion of either or both such trusts under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code. The ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return. *See* 1.1361–1(m).

(b) *Definitions* —(1) *Grantor portion.* The grantor portion of an ESBT is the portion of the trust that is treated as owned by the grantor or another person under subpart E.

(2) *S portion.* The S portion of an ESBT is the portion of the trust that consists of S corporation stock and that is not treated as owned by the grantor or another person under subpart E.

(3) *Non-S portion.* The non-S portion of an ESBT is the portion of the trust that consists of all assets other than S corporation stock and that is not treated as owned by the grantor or another person under subpart E.

(c) *Taxation of grantor portion.* The grantor or another person who is treated as the owner of a portion of the ESBT includes in computing taxable income items of income, deductions, and credits against tax attributable to that portion of the ESBT under section 671.

(d) *Taxation of S portion* —(1) *In general.* The taxable income of the S portion is determined by taking into account only the items of income, loss, deduction, or credit specified in paragraphs (d)(2), (3), and (4) of this section, to the extent not attributable to the grantor portion.

(2) *Section 1366 amounts* —(i) *In general.* The S portion takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to section 1366 and the regulations thereunder. Rules otherwise applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account in determining the taxable income of the S portion. *See* 1.1361–1(m)(3)(iv) for allocation of those items in the taxable year of the S corporation in which the trust is an ESBT for part of the year and an eligible shareholder under section 1361(a)(2)(A)(i) through (iv) for the rest of the year.

(ii) *Special rule for charitable contributions.* If a deduction described in paragraph (d)(2)(i) of this section is attributable to an amount of the S

corporation's gross income that is paid by the S corporation for a charitable purpose specified in section 170(c) (without regard to section 170(c)(2)(A)), the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument within the meaning of section 642(c)(1). The limitations of section 681, regarding unrelated business income, apply in determining whether the contribution is deductible in computing the taxable income of the S portion.

(iii) *Multiple S corporations.* If an ESBT owns stock in more than one S corporation, items of income, loss, deduction, or credit from all the S corporations are aggregated for purposes of determining the S portion's taxable income.

(3) *Gains and losses on disposition of S stock* —(i) *In general.* The S portion takes into account any gain or loss from the disposition of S corporation stock. No deduction is allowed under section 1211(b)(1) and (2) for capital losses that exceed capital gains.

(ii) *Installment method.* If income from the sale or disposition of stock in an S corporation is reported by the trust on the installment method, the income recognized under this method is taken into account by the S portion. See paragraph (g)(3) of this section for the treatment of interest on the installment obligation. See 1.1361–1(m)(5)(ii) regarding treatment of a trust as an ESBT upon the sale of all S corporation stock using the installment method.

(iii) *Distributions in excess of basis.* Gain recognized under section 1368(b)(2) from distributions in excess of the ESBT's basis in its S corporation stock is taken into account by the S portion.

(4) *State and local income taxes and administrative expenses* —(i) *In general.* State and local income taxes and administrative expenses directly related to the S portion and those allocated to that portion in accordance with paragraph (h) are taken into account by the S portion.

(ii) *Special rule for certain interest.* Interest paid by the trust on money borrowed by the trust to purchase stock in an S corporation is allocated to the S portion but is not a deductible administrative expense for purposes of determining the taxable income of the S portion.

(e) *Tax rates and exemption of S portion* —(1) *Income tax rate.* Except for capital gains, the highest marginal trust rate provided in Section 1(e) is applied to the taxable income of the S portion. See section 1(h) for the rates that apply to the S portion's net capital gain.

(2) *Alternative minimum tax exemption.* The exemption amount of the S portion under section 55(d) is zero.

(f) *Adjustments to basis of stock in the S portion under section 1367.* The basis of S corporation stock in the S portion must be adjusted in accordance with section 1367 and the regulations thereunder. If the ESBT owns stock in more than one S corporation, the

adjustments to the basis in the S corporation stock of each S corporation must be determined separately with respect to each S corporation. Accordingly, items of income, loss, deduction, or credit of an S corporation that are taken into account by the ESBT under section 1366 can only result in an adjustment to the basis of the stock of that S corporation and cannot affect the basis in the stock of the other S corporations held by the ESBT.

(g) *Taxation of non-S portion* —(1) *In general.* The taxable income of the non-S portion is determined by taking into account all items of income, deduction, and credit to the extent not taken into account by either the grantor portion or the S portion. The items attributable to the non-S portion are taxed under subparts A through D of part I, subchapter J, chapter 1 of the Internal Revenue Code. The non-S portion may consist of more than one share pursuant to section 663(c).

(2) *Dividend income under section 1368(c)(2).* Any dividend income within the meaning of section 1368(c)(2) is includible in the gross income of the non-S portion.

(3) *Interest on installment obligations.* If income from the sale or disposition of stock in an S corporation is reported by the trust on the installment method, the interest on the installment obligation is includible in the gross income of the non-S portion. See paragraph (d)(3)(ii) of this section for the treatment of income from such a sale or disposition.

(4) *Charitable deduction.* For purposes of applying section 642(c)(1) to payments made by the trust for a charitable purpose, the amount of gross income of the trust is limited to the gross income of the non-S portion. See paragraph (d)(2)(ii) of this section for special rules concerning charitable contributions paid by the S corporation that are deemed to be paid by the S portion.

(h) *Allocation of State and local income taxes and administration expenses.* Whenever State and local income taxes or administration expenses relate to more than one portion of an ESBT, they must be allocated between or among the portions to which they relate. These items may be allocated in any manner that is reasonable in light of all the circumstances, including the terms of the governing instrument, applicable local law, and the practice of the trustee with respect to the trust if it is reasonable and consistent. The taxes and expenses apportioned to each portion of the ESBT are taken into account by that portion.

(i) *Treatment of distributions from the trust.* Distributions to beneficiaries from the S portion or the non-S portion, including distributions of the S corporation stock, are deductible under section 651 or 661 in determining the taxable income of the non-S portion, and are includible in the gross income of the beneficiaries under section 652 or 662. However, the amount of the deduction or inclusion cannot exceed the amount of the distributable net income of the non-S portion. Items of income, loss, deduction, or credit taken into account by the grantor portion or the S

portion are excluded for purposes of determining the distributable net income of the non-S portion of the trust.

(j) *Termination or revocation of ESBT election.* If the ESBT election of the trust terminates pursuant to 1.1361–1(m)(5) or the ESBT election is revoked pursuant to 1.1361–1(m)(6), the rules contained in this section are thereafter not applicable to the trust. If, upon termination or revocation, the S portion has a net operating loss under section 172; a capital loss carryover under section 1212; or deductions in excess of gross income; then any such loss, carryover, or excess deductions shall be allowed as a deduction, in accordance with the regulations under section 642(h), to the trust, or to the beneficiaries succeeding to the property of the trust if the entire trust terminates.

(k) *Effective date.* This section generally is applicable for taxable years of ESBTs beginning on and after May 14, 2002. However, paragraphs (a), (b), (c), and (l) *Example 1* of this section are applicable for taxable years of ESBTs that end on and after December 29, 2000. ESBTs may apply paragraphs (d)(4) and (h) of this section for taxable years of
ESBTs beginning after December 31, 1996.

IT 2000-01 - Grantor Trust Provisions Take Precedence Over ESBT Provisions - January 19, 2000

Effective for individual and estate taxable years beginning after December 31, 1999, the Income Tax Audit Division will require certain individuals and estates to include in their Federal adjusted gross income ("FAGI") and Ohio taxable income all relevant pass-through items of income, gain or loss from S corporations when such items have been treated as reportable for Federal income tax purposes on a trust's fiduciary income tax return (Form 1041) because the trust has elected to be taxed as an Electing Small Business Trust ("ESBT") under Internal Revenue Code ("IRC") section 1361(e)(3). Specifically, if an individual or estate would be treated as the owner of all or a portion of a trust pursuant to IRC Section 671 et seq., then such individual or estate shall include in his, her or its FAGI or Ohio taxable income all relevant S corporation pass-through items as if the individual or estate were itself the actual owner of the S corporation stock owned by the trust.[1]

Furthermore, because the Income Tax Audit Division will treat such trusts as grantor trusts rather than as ESBT's, the trust cannot qualify as an electing small business trust excluded, under Ohio Revised Code ("ORC") section 5733.40(I)(1), from the definition

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[1] Of course, individuals and estates will not have to make these adjustments to the extent these individuals and estates have already done so on their Federal income tax returns.

of a "qualifying investor." As such, for taxable years beginning after December 31, 1999, an S corporation must pay the 5% pass-through entity withholding tax and related estimated tax (ORC sections 5747.41 and 5747.43) with respect to "adjusted qualifying amounts" (ORC section 5733.40(A)(1)(a)) which pass through to such trusts.

For taxable years beginning after December 31, 1999, assessments for unpaid tax and all related failure to timely pay and failure to timely file charges will apply (i) to such individuals and estates who do not adjust their FAGI and Ohio taxable income (and timely pay tax and related estimated tax thereon) in accordance with this information release and (ii) to S corporations which do not timely pay the 5% withholding tax and the related estimated tax with respect to such S corporation distributive shares.

Discussion.

The Internal Revenue Code does not contain any provisions which expressly state that an ESBT which also qualifies as and/or is described as a grantor trust is exempt from the grantor trust provisions. Neither does the "Blue Book" provide or address any such exemption.[5] In fact, the principal advocate of the ESBT legislation has cautioned that the provisions of an ESBT's governing instruments ". . . should be limited so that no power would result in the inclusion

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[2] Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 104th Congress.

of trust assets or revenue in the trustee's own estate or income."[6] Thus, even the principal advocate of the ESBT legislation implicitly recognizes that an ESBT which also qualifies as and/or is described as a grantor trust is, in fact, subject to the grantor trust provisions for taxation rather than qualifying for the special rules for taxation of ESBTs under IRC Section 641(c).

The Income Tax Audit Division recognizes that various tax practitioners have differing interpretations of how the ESBT provisions interplay with the grantor trust provisions of the Internal Revenue Code. Some have advocated that the ESBT provisions should take precedence over the grantor trust provisions, while others believe that a grantor trust cannot make the ESBT election.[7] In light of the fact that neither the

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[3] See the last sentence of Frederick G. Corneel's article, "The Electing Small Business Trust: Subchapter S's User-Friendly Estate Planning Tool" beginning on page 215 of the April, 1997 issue of the Journal of Taxation. The "Editor's Note" appearing in that article states as follows:

"Mr. Corneel was the principal advocate on Capitol Hill for ESBTs, and he worked with the staffs of both the Joint Committee and Treasury in drafting the legislation.

> . . . Moreover, until there is Treasury guidance or further legislation, his analysis of the law stands as uniquely important to any potential users of this new estate planning tool."

[4] See item number 4 in the American Institute of Certified Public Accountants December 21, 1999 correspondence to IRS Assistant Chief Counsel Paul F. Kugler. That letter is

U.S. Treasury Department nor the Internal Revenue Service has issued any guidance in this area, and barring any change in the Federal tax law or issuance of new U.S. Treasury regulations to the contrary, the Income Tax Audit Division's position is that a grantor trust cannot make the ESBT election. If you have questions regarding this information release, please contact the Income Tax Audit Division at 614-433-7610 (TTY: 1-800-750-0750).

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reproduced in the December 29, 1999 edition of BNA, Inc.'s TaxCore. But see Apple, "Ohio Income Tax Treatment of The Newest "S" Corporation Shareholder: The Electing Small Business Trust," The Ohio CPA Journal, April - June, 1998 on page 29, 4th line down: "Grantor trusts cannot elect to be treated as an ESBT."

KNUST v. WILKINS, 111 Ohio St.3d 331 (2006)
2006-Ohio-5791

KNUST ET AL., APPELLANTS, v. WILKINS, TAX COMMR., APPELLEE

No. 2005-2084

Supreme Court of Ohio
Submitted June 6, 2006
Decided November 22, 2006

APPEAL from the Board of Tax Appeals, No. 2004-M-533.

O'CONNOR, J.

{¶ 1} A husband and wife contend in this appeal that they should not be required to pay Ohio personal income tax on the income earned by two trusts that they created. The Tax Commissioner and the Board of Tax Appeals ("BTA") concluded, however, that the trusts' income passed through the trusts and was taxable to the husband and wife themselves. That conclusion was a sound one, and we therefore affirm the BTA's decision.
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Facts and Procedural History

{¶ 2} The appellants — David G. Knust and Susan Purkrabek-Knust — are a married couple in

Cincinnati. They established a corporation in 1983 called Precision Packaging & Services, Inc. As the name suggests, the company provided packaging services, and both David and Susan worked at the company, served as officers of the company, and were its sole shareholders initially.

{¶ 3} Starting in 1995, David and Susan elected to treat the packaging company as a Subchapter S corporation (often referred to as an "S corporation"). As this court has explained, "Subchapter S of the Internal Revenue Code (Section 1361 *et seq.*, Title 26, U.S.Code) permits the owners of qualifying corporations to elect a special tax status under which the corporation and its shareholders receive conduit-type taxation that is comparable to partnership taxation." *Ardire v. Tracy* (1997), **77 Ohio St.3d 409, 674 N.E.2d 1155**, fn. 1. "For tax purposes, a Subchapter S corporation differs significantly from a normal corporation in that the profits generated through the S corporation are taxed as personal income to the shareholders. The taxable income of an S corporation is computed essentially as if the corporation were an individual." Id.

{¶ 4} Then, in 1998, David and Susan created separate trusts, which they named the David Knust Grantor Trust and the Susan Purkrabek Grantor Trust. Both David and Susan transferred their shares of the packaging company's stock to their respective trusts.

{¶ 5} David named himself as the sole trustee of his trust, and Susan named herself the sole trustee of her

trust. Each of them also chose in 1998 to designate their respective trusts as "electing small business trusts" or "ESBTs" under the Internal Revenue Code. See Section 641(c), Title 26, U.S. Code.

{¶ 6} On February 26, 2000, the two trusts sold their shares of the packaging company to a separate corporate entity in which David and Susan held no interest. Each trust received more than $16 million for the sale of the company's shares, and both trusts paid Federal income tax on those sale proceeds.

{¶ 7} On their joint Ohio income tax return for the year 2000, David and Susan reported the proceeds from the sale as personal income to them, and they paid Ohio income tax on those proceeds in April 2001. They then asked the Tax Commissioner in late April 2001 to refund more than $2 million of the income taxes that they had just paid for tax year 2000, contending that the income received by the two trusts from the sale of the packaging company's shares should not have been treated by Ohio as taxable personal income to David and Susan themselves.

{¶ 8} The Tax Commissioner issued a final determination in 2004 denying David and Susan's refund claim for tax year 2000. David and Susan then Page 333
challenged that decision before the BTA, which held a hearing on the matter in December 2004.

{¶ 9} The BTA agreed with the Tax Commissioner, concluding that the two trusts were "grantor trusts" —

that is, they were trusts over which David and Susan, as the creators and trustees of the trusts, retained substantial control — and therefore the income received by the trusts was properly taxable to David and Susan themselves. The ordinary rule for the taxation of a grantor trust that any income earned by the trust is taxed not to the trust but rather to the grantor himself or herself — is not changed, according to the BTA, by the fact that the trust has been designated as an "electing small business trust" under the Internal Revenue Code. The BTA therefore affirmed the Tax Commissioner's decision to deny David and Susan's refund claim.

{¶ 10} David and Susan have now appealed to this court.

Standard of Review

{¶ 11} In reviewing a BTA decision, this court must determine whether that decision was "reasonable and lawful." *Columbus City School Dist. Bd. of Edn. v. Zaino* (2001), 90 Ohio St.3d 496, 497, 739 N.E.2d 783; R.C. 5717.04. The court "will not hesitate to reverse a BTA decision that is based on an incorrect legal conclusion." *Gahanna-Jefferson Local School Dist. Bd. of Edn. v. Zaino* (2001), 93 Ohio St.3d 231, 232, 754 N.E.2d 789. But "[t]he BTA is responsible for determining factual issues and, if the record contains reliable and probative support for these BTA determinations," this court will affirm them. *Am. Natl. Can Co. v. Tracy* (1995), 72 Ohio St.3d 150, 152, 648 N.E.2d 483.

{¶ 12} The burden of proof rests on the taxpayer "to show the manner and extent of the error in the Tax Commissioner's final determination." *Standards Testing Laboratories, Inc. v. Zaino*, 100 Ohio St.3d 240, 2003-Ohio-5804, 797 N.E.2d 1278, H 30. The Tax Commissioner's findings "are presumptively valid, absent a demonstration that those findings are clearly unreasonable or unlawful." *Nusseibeh v. Zaino*, 98 Ohio St.3d 292, 2003-Ohio-855, 784 N.E.2d 93, ¶ 10.

Analysis

{¶ 13} We must determine in this case whether the income earned in the year 2000 by David and Susan's trusts was part of David and Susan's own "adjusted gross income" for that year.

{¶ 14} As we previously explained, "Ohio has imposed -- in R.C. 5747.02(A) — a tax on the `adjusted gross income' of individuals and has defined `adjusted gross income' in R.C. 5747.01(A) as `Federal adjusted gross income, as defined and used in the Internal Revenue Code, adjusted as provided in this section.' In other words, the adjusted gross income of Ohio residents and those who earn or receive
Page 334 income in Ohio is taxed, and in calculating each taxpayer's `adjusted gross income,' Ohio looks to the definition that Congress has given to that term in the Internal Revenue Code." *Buckley v. Wilkins*, 105 Ohio St.3d 350, 2005-Ohio-2166, 826 N.E.2d 811, ¶ 8.

{¶ 15} An individual taxpayer's adjusted gross income

under the Internal Revenue Code includes "gross income" minus certain deductions not at issue in this case, and gross income includes income from various sources, including income received by the taxpayer from a trust. See Sections 61(a)(15) and 62(a), Title 26, U.S.Code.

{¶ 16} The Internal Revenue Code also indicates that income earned by a grantor trust is taxable to the grantor rather than to the trust itself. See Sections 671 to 679, Title 26, U.S.Code. Time and again, Federal courts have applied those statutory provisions to grantor trusts. See, e.g., *Schulz v. Commr. of Internal Revenue* (C.A.7, 1982), 686 F.2d 490, 495 ("The main thrust of the grantor trust provisions is that the trust will be ignored and the grantor treated as the appropriate taxpayer whenever the grantor has substantially unfettered powers of disposition"); *Neely v. United States* (C.A.9, 1985), 775 F.2d 1092, 1094 ("Under 26 U.S.C. §§ 671-677 (1982), a grantor of a trust who has retained certain powers of disposition which may be exercised without the approval or consent of an adverse party is treated as the owner of the trust and, thus, is taxed individually").

{¶ 17} The Tax Commissioner concluded that the two trusts in question were in fact grantor trusts, and the BTA agreed. That conclusion is a sound one and is not challenged by David or Susan, who were each entitled — according to the trust documents that they signed in 1998 — to "sell or exchange, publicly or privately, any assets, real or personal" in their respective trusts. Also, they both expressly designated

their trusts as grantor trusts, they both named themselves as the sole trustee of their respective trusts, they were each entitled to reclaim all or part of the trust assets and to receive all net income earned by their respective trusts, and they both reserved the right under the trust agreements to amend or revoke those agreements.

{¶ 18} Even though their trusts were grantor trusts, David and Susan contend that the income earned by those trusts was not taxable to them personally, because they had designated the trusts as "electing small business trusts" or "ESBTs." That special designation, they claim, changes the basic rule that the income earned by a grantor trust should be treated as taxable income to the grantor himself or herself.

{¶ 19} Congress created the ESBT designation in 1996, Pub.L. No. 104-188, 110 Stat. 1755, and gave trusts that were designated as ESBTs the power to own stock in S corporations. See Section 1361(c)(2)(A)(v), Title 26, U.S.Code. A trust
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can qualify as an ESBT if its only beneficiaries are individuals, estates, or certain organizations listed in the Internal Revenue Code. See Section 1361(e)(1)(A)(i), Title 26, U.S.Code.

{¶ 20} There is no dispute in this case that David and Susan designated their trusts as ESBTs when they created those trusts in 1998. And, as the BTA found, both David and Susan undeniably transferred all of the shares of their packaging company — an S corporation

— to those trusts in 1998.

{¶ 21} The only question, then, is whether the trusts' status as ESBTs changed the taxability of the income that those grantor trusts earned. We conclude — like the Tax Commissioner and the BTA — that it did not. The income that the trusts earned when they sold the shares of the packaging company in 2000 is properly treated as part of David and Susan's own adjusted gross income for that year.

{¶ 22} According to David and Susan, the income earned by their trusts should be taxed under Section 641(c), Title 26, U.S.Code. That provision explains how taxes are to be calculated on any portion of an ESBT that owns stock in one or more S corporations when an income tax is "imposed by this chapter [Section 1 et seq., Title 26, U.S.Code] on such separate trust." Section 641(c)(1)(A) and (B), Title 26, U.S.Code.

{¶ 23} Title 26 of the U.S. Code, however, does not impose an income tax on grantor trusts. See Ferguson, Freeland & Ascher, Federal Income Taxation of Estates, Trusts, and Beneficiaries (3d Ed.2000) 10-25 to 10-26, Section 10.05[C] ("If a grantor is treated as owner of an entire trust, * * * the trust has no tax liability to compute. Basically, therefore, the trust is completely ignored for income tax purposes"); Danforth, A Proposal for Integrating the Income and Transfer Taxation of Trusts (1999), 18 Va. Tax Rev. 545, 546
("under the so-called grantor trust rules of [Sections 671 to 679, Title 26, U.S.Code], a trust is not treated as

a separate taxable entity if the grantor retains a sufficient degree of control over or beneficial interest in the trust").

{¶ 24} Instead, the income earned by a grantor trust passes through to the grantor and is taxed to him or her under Sections 671 to 679, Title 26, U.S.Code. See Rev. Rul. 90-7, 1990-1 C.B. 153 ("When a grantor is treated as the owner of an entire trust, the grantor is considered to be the owner of the trust assets for Federal income tax purposes"); Ferguson, Freeland & Ascher, supra, at 10-26, Section 10.05[C] ("The grantor takes into account all its items of income, deductions, and credits in computing his or her tax liability").

{¶ 25} Nothing in the statutory provision cited by David and Susan — Section 641(c), Title 26, U.S. Code — suggests that that principle changes when the grantor trust is designated as an ESBT. That statute simply says that when an income tax is imposed on a trust, that tax is to be calculated in a specified way if the trust is an ESBT. Where, as in this case, no income tax is imposed on the trust,

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however, the statute does not come into play. In other words, a grantor trust can elect ESBT status, but that status does not change the ordinary requirement that the grantor trust's income is taxed to the grantor and not to the trust itself. Grantor trusts pay no tax on the income they earn, and therefore the provisions of Section 641(c) concerning the calculation of taxes on an electing-small-business trust do not apply if the ESBT is a grantor trust.

{¶ 26} The BTA reached that same conclusion, explaining that "the determination that an ESBT trust is a grantor trust * * * controls the manner of taxation" for that trust. According to the BTA, there is no support "for the appellants' claim that an ESBT election overrides grantor trust rules." As explained above, the BTA's decision is consistent with the relevant provisions of the Internal Revenue Code.

{¶ 27} It is notable that the two trusts filed separate Federal income tax returns for the year 2000 claiming the income earned by the trusts during that year as taxable to the trusts themselves rather than to David and Susan individually. That is, the appellants failed to include, as part of their own 2000 Federal adjusted gross income, the income that their grantor trusts earned. Yet as the BTA rightly explained, "the Tax Commissioner is not confined to follow" a taxpayer's statement that certain income should be excluded from the taxpayer's Federal adjusted gross income.

{¶ 28} Like the Tax Commissioner and the BTA, we conclude that David and Susan should have included on their individual Federal income tax returns the income that the grantor trusts earned. The failure of the Internal Revenue Service to insist that the returns be changed to reflect the trust income as personal income — a failure explained, perhaps, by the fact that ESBT trusts pay "the highest rate of tax" under Section 641(c)(2)(A), Title 26, U.S. Code, on any taxable income — does not prevent the Tax Commissioner or this court from applying the Federal statutes as they are written.

{¶ 29} The BTA's conclusion is also supported by a Federal regulation that amplifies the statutory provisions discussed above. According to Section 1.641(c)-1(c), Title 26, C.F.R., an ESBT that is also a grantor trust is taxed like an ordinary grantor trust: "[t]he grantor * * * includes" in his or her own taxable income those "items of income * * * attributable to * * * the ESBT under [Section 671, Title 26, U.S. Code]."

{¶ 30} Admittedly, that regulation is "applicable for taxable years of ESBTs that end on and after December 29, 2000." Section 1.641(c)-1(k), Title 26, C.F.R. David and Susan argue that the regulation does not apply to their trusts because the trusts sold the packaging company's shares on February 26, 2000. The *taxable year* in question for David and Susan's trusts ended on December 31, 2000, however, as is shown on the face of the Federal income tax returns that they
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filed for those trusts. Even if, as they contend, the ESBT status of their trusts ended once the packaging company's assets were sold by the trusts in February 2000, they have offered no separate tax returns suggesting that they treated the taxable year for the ESBTs as having ended on any date earlier than December 31, 2000. The regulation therefore *does* apply to them, and that regulation reinforces the conclusion that the BTA rightly drew from the relevant statutes: that David and Susan themselves owed State income tax on the income earned by their grantor trusts during tax year 2000.

Conclusion

{¶ 31} The BTA's conclusion that income earned by a grantor trust is taxable to the grantor rather than to the trust itself — even if the trust is an ESBT — is supported by the relevant Federal statutes. The BTA's decision is reasonable and lawful, and we therefore affirm it.

Decision affirmed.

MOYER, C.J., RESNICK, PFEIFER, LUNDBERG STRATTON and LANZINGER, JJ., concur.

O'DONNELL, J., dissents.

O'DONNELL, J., dissenting.

{¶ 32} In 1998, David and Susan Knust created separate grantor trusts funded with shares of their packaging company, Precision Packaging & Services, Inc. At that time, they designated those trusts as "electing small business trusts" ("ESBTs") pursuant to Section 641(c), Title 26, U.S.Code. On February 26, 2000, David and Susan sold their shares of Precision Packaging, which resulted in the termination of both ESBTs as of that date. Because this sale terminated the trusts prior to the applicability of the Treasury Regulation upon which the majority relies, the income earned by the trust is not taxable to David and Susan individually. Accordingly, I respectfully dissent from the decision of the majority to the contrary.

{¶ 33} Section 443(a), Title 26, U.S. Code, provides:

{¶ 34} "A return for a period of less than 12 months

(referred to in this section as `short period') *shall* be made under any of the following circumstances:

{¶ 35} "(2) When the taxpayer is in existence during only part of what would otherwise be his taxable year." (Emphasis added.)

{¶ 36} The trusts in question terminated on February 26, 2000, and, therefore, their taxable year ended on that date. Treasury Regulation 1.641(c)-1(k), upon which the majority relies, is "applicable for taxable years of ESBTs that end *on and after* December 29, 2000." (Emphasis added.) Section 1.641(c)-1(k), Title 26,
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C.F.R. Because the ESBTs had terminated prior to December 29, 2000, the Treasury Regulation does not apply to them. The majority attempts to circumvent this regulation and the plain language of Section 443(a) by stating that David and Susan "offered no separate tax returns suggesting that they treated the taxable year for the ESBTs as having ended on any date earlier than December 31, 2000." In my view, this point is not persuasive, because Section 443(a) provides that a "short period" tax return "shall be made" when a taxpayer ceases to exist during a tax year. The tax year in question, therefore, terminated when the taxpayer ceased to exist regardless of the date indicated on the tax return.

{¶ 37} Tellingly, the Internal Revenue Service did not demand that the taxpayer alter the ESBT returns to reflect the trust income as personal income. Because

this case involves the application of a Federal tax statute, and because the Internal Revenue Service did not require David or Susan to amend their tax returns as the Commissioner has, I would hold that the ESBT income is not taxable to David or Susan individually.

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